MINISTRY OF FINANCE

FLASH REPORT

on key economic and financial processes based on the January-August 2004 data

Budapest, 22 September 2004

TABLE OF CONTENTS[1]

[1]This report is available on the official website of the Ministry of Finance (www.p-m.hu)

Summary

Data concerning every economic sector are available now for the first half of the year – indeed, in some sectors for an even longer period. In light of this, the review of the past projections is now well-founded. Actual trends indicate that the growth of the Hungarian economy in 2004 will be more dynamic than previously expected. It is due to the growth of all three demand-side GDP factors at a rate faster than originally expected. Similarly to most EU Member States, the rate of inflation is higher than projected by few tenths of percentage points primarily due to permanently high oil prices, however, its declining trend will resume in the second half of the year. Despite the ever-growing funding needs of the corporate sector the current account deficit as a percentage of GDP does not exceed the last year's level as a result of the 1 percentage point lower budget deficit compared to that of 2003, even though the target will not be fulfilled. The extent of the decline is one of the best in the EU.

In international trends, which are of utmost importance for the small, open Hungarian economy, changes favourable to us have occurred recently, though their foundations and duration are still not clear. It is certain now that in 2004 both the global economy and the European Union will experience faster growth than previously projected. The main risk factor in the growth prospects, which continue to be encouraging, is the permanently high level of crude oil prices.

So far, our economy has been able to exploit the favourable external economic trends. Hungarian growth, which continues to be twice as much as the EU average, which has also increased, has resumed its export driven growth path. For the elaboration of the GDP forecast for 2004, we must reckon with a declining quarterly growth rate in the second half of the year due to the high base, but even so a dynamic growth of around 3.8-3.9% is projected for the whole of the year.

The intensive growth of exports continued in the second quarter, accompanied by a similar increase in imports. However, non-recurring factors reflected in export performance (tactical pre-accession purchases, discharge from customs warehouses) indicate an inventory accumulation which in turn gives rise to expectations of a more modest growth in imports and therefore in the current account deficit in the second half of the year.

In the first half-year, fast-growing investments were the second important factor of growth in addition to exports. In this period, investments in manufacturing, which are essential for the acceleration of growth, have increased extremely dynamically by 21%.

The growth of household consumption accelerated in the second quarter, as a result of one-off factors, namely major motor vehicle purchases due to the introduction of the registration tax. Data available at this stage on the income side (real wage growth slowing down considerably, household savings slightly increasing) do not underpin the acceleration of consumption in excess of the projected level. Therefore we do not expect consumption to recapture the leading role in growth for the entire year.

The trend of inflation was in accordance with expectations, but its rate was higher than forecasted. Two fifths of the 4.9% price increase during the first eight months of the year is caused by pre-planned, non-recurring VAT and excise tax changes relating to EU membership. The additional inflation above the expected level was definitely due to the international fuel and raw material price increases. This is also supported by the fact that the trend of the constant tax-content index shows a similar curve to the price changes in EU Member States. In light of this, a declining rate of inflation is expected for the second half of the year.

The general government deficit for the first eight months exceeded the annual target. The excess deficit is due to revenues not realised resulted from developments during the year (VAT loss after accession, personal income tax reimbursements). Following the reassessment of developments, the Government reset the annual deficit target which according to ESA 95 may be around 5-5.3% of GDP instead of the previous 4.6%. Simultaneously, the Government also adopted measures to improve the balance (sale of Treasury property, collection of dividends from state-owned enterprises, prevention of the spending of surplus revenues at extra-budgetary funds, more stringent tax and excise controls at the borders). By reviewing the deficit target and adopting of expenditure cuts, the Government intended to strengthen the credibility and predictability of economic policy. It was also strengthened by the Government's declaration that it would not abandon the goal of fulfilling the fiscal path set out in the Convergence Programme.

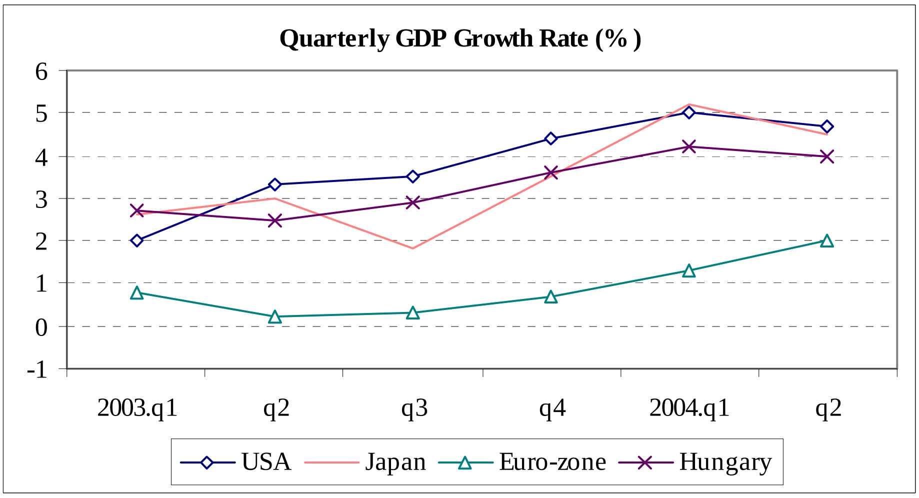
Monetary conditions continue to be very tight. The central bank's policy rate is the highest in the European Union. On the other hand, the exchange rate is stronger than it was a year ago, and its trend is stable. High interest rates increase budget expenditures and necessitate greater adjustments in the primary balance, while encouraging households and businesses to resort to foreign exchange borrowing.

1. International environment

Late in 2003 and early in 2004 the global economy was characterised by fast growth. The US and the Asian countries were the driving forces of growth. The performance of the EU countries improved with some delay and at a lower rate, but it has become clear by now that the recovery has been more marked than forecasted and expected more extensive in sectoral and regional terms.

Global economic boom will be higher than forecasted.

The most recent figures about the most dynamically growing regions of the world economy appear to indicate that growth has peaked and even though the growth rate will continue to be robust, a slight deceleration is possible partly for cyclical reasons and partly because of the lasting high level of crude oil prices. In the **US**, the rate of growth slowed down, mainly because of the slower growth of household consumption, and this process is expected to continue. The permanently high energy prices, the budget cuts and the increased tax burdens on households do not favour a dynamic consumption growth. The growth rate in **Asia** will remain relatively high despite the expected decline. In Japan, in spite of the favourable external demand, the slow-down in the second quarter is attributable to the slower growth of investments due to fiscal consolidation. The improvement of business and household confidence allows for the acceleration of growth again, even though it approximates the potential level. In China, the measures adopted to curb the fast growth of recent years have come to fruition, also reducing to the growth rate of the global economy. In the other Asian countries dynamic growth has continued.



The output of the **EU economies** was better than expected in the first half-year (Q1 2204: 1.7%, Q2: 2.3%). The higher growth is attributable, to an extent varying from country to country, to export growth and an upswing in household consumption, while the unexpected poor performance of private investments had a contrary effect. The positive development is present in every Member State, but the growth of recently joined countries is significantly faster because of the pressure to catch up. The spring forecasts were based on the assumption of oil prices lower than they are today. However, monetary and financial conditions are relatively stable, as, despite the slightly higher inflation, considered to be a temporary phenomenon, and alongside the relatively lower rate of economic growth, the ECB did not increase interest rates, while it adjusted the GDP growth forecasts downwards (1.6-2.2% for 2004, 1.8-2.8 % for 2005).

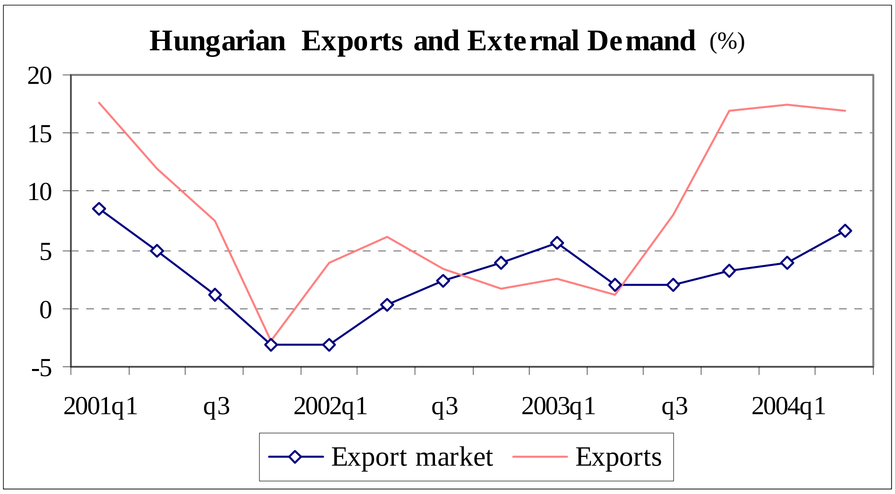
Crude oil price is a downside risk.

Against the background of good short and medium term prospects, the main risk in forecasts is the permanently high level of oil prices. As a direct and indirect result, the increase of domestic demand may come to a halt, and external demand and export prospects may be reduced. This hazard applies also to EU countries, even though in energy terms they are less dependent than in the seventies and eighties, and the strong euro may partially eliminate the effects of the dollar price increase. On the other hand, the growth rate may be accelerated if the internal demand in EU countries picks up, which would enhance the potential for the self-sustainability of growth. This assumption is apparently supported by the latest investment figures and business cycle indices. The stronger the endogenous factors of growth, the smaller the growth risk of the effects of crude oil price increase.

As the growth cycle enters a more advances phase and economic policy gradually assumes a more neutral course, the growth rate of the global economy is expected to decline somewhat in 2005. Even though global growth is excepted to remain favourable, with Asia playing an ever more important role in this, EU economies must expect a slight decline in external demand and the belated effects of the permanently high oil price. Thus the growth of 2004, which is more dynamic than previously expected, does not at this point justify any further correction in the year 2005 forecasts.

As to Hungary, the **favourable external business cycle** has been **exploited** and Hungarian growth, which is currently twice the EU average, has resumed its export driven course since Q3 2003. The beneficial effects of this on the equilibrium may be exerted only in the long term, because first, before the export expansion, the upturn in import demand will increase the deficit. For Hungary, the primary risk of growth prospects is in the external economic cycle. We heavily depend on EU markets, therefore in the medium term the relatively good EU outlook may improve our prospects. The successful implementation of Hungarian foreign trade policy aiming at diversification, by expanding the markets of the dynamic Asian regions and of Russia, may make favourable cyclical impacts more lasting and deeper, but this change can be implemented only gradually and within limits.

So far, the Hungarian economy has exploited the favourable external business cycle.



2. Growth and its factors

2.1 Foreign trade

In the first seven months of 2004, export growth continued to be dynamic, at approx. 17% in volume. The 20% export growth in the first quarter declined to 16% in the second quarter. The export data for April are incomplete[2], but the CSO estimates (based on information from the corporate sector) that actual data would show an export expansion of 17.5% in Q2.

In the second half-year, the dynamic expansion of exports continue …

In January-July import expanded by approx. 16%, its rate below that of exports. Import trends were affected by several non-recurring factors (tactical import purchases before EU accession, discharge from customs

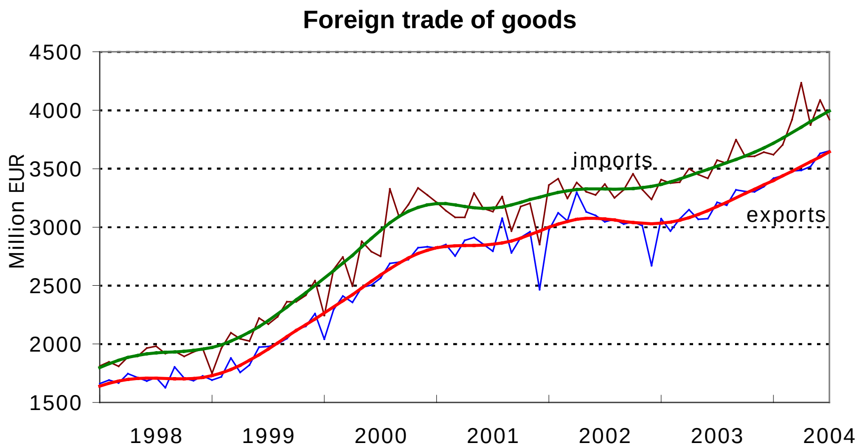
… in line with a more modest growth of imports.

[2] Export documentation of approx. EU 140 million remained, unforwarded for statistical processing, in the closed-down customs offices.

warehouses of accumulated EU imports irrespective of their use and their inclusion in statistics). These factors in aggregate contributed some 3-4 percentage points (approximately EUR 1 billion) to import growth. Some of the import pre-purchased in March-April and discharged in May-July has been actually used. Based on domestic consumption and monthly import trends, this is estimated to be around EUR 400-500 million. Thus the import consumption arising from actual developments of the real economy increased by about 14% in January-July. The remaining EUR 500-600 million imported "inventory" will reduce imports and the increase of the commodity trade deficit in the second half-year.

The deterioration of the external balance was caused by temporary factors.

The **deficit of the balance of trade** reached EUR 3 billion in the first seven months, 0.3 billion greater than in the base period. However, if the non-recurring effects on import and the missing exports of April are also taken into consideration, the balance of trade deficit was only EUR 2.4 billion, representing an approx. EUR 300 billion balance improvement over 2003. The increase of the statistical deficit was generated entirely in the trade with non-EU countries due to the dynamic growth of importation for export purposes (assembly of Chinese parts in Hungary and their exportation into the EU).



We have **detailed** statistical data in a breakdown by product and by country for the first half-year, therefore the structural evaluation of export-import by categories of countries below relate to the first half-year data.[3]

Export growth was driven by the exportation of machinery.

The export **commodity structure** of foreign trade continued to be dominated in the first six months by **machinery** exports: the 24% volume growth represented three quarters of total export growth. The exportation of communications products, machinery and equipment showed the highest growth (by 26 and 21%, respectively, in euro terms).

[3] In the new statistical system, the CSO, at first publication, discloses a macro-estimate for the expected actual figures. The second publication (in our case, the first half-year data) contains the corporate and customs data received so far, which correspond to the former preliminary data; the CSO does not estimate any subsequent "replenishment", as in the new statistical system they do not have sufficient time series data available. Because of the conversion, the reliability of statistics has deteriorated significantly.

The exportation of manufactured goods increased less than the average, by approx. 11%, but it represented close to 20% of export growth due to its volume; within this category, the export of pharmaceuticals showed an especially dynamic increase. The exportation of food and agricultural products declined.

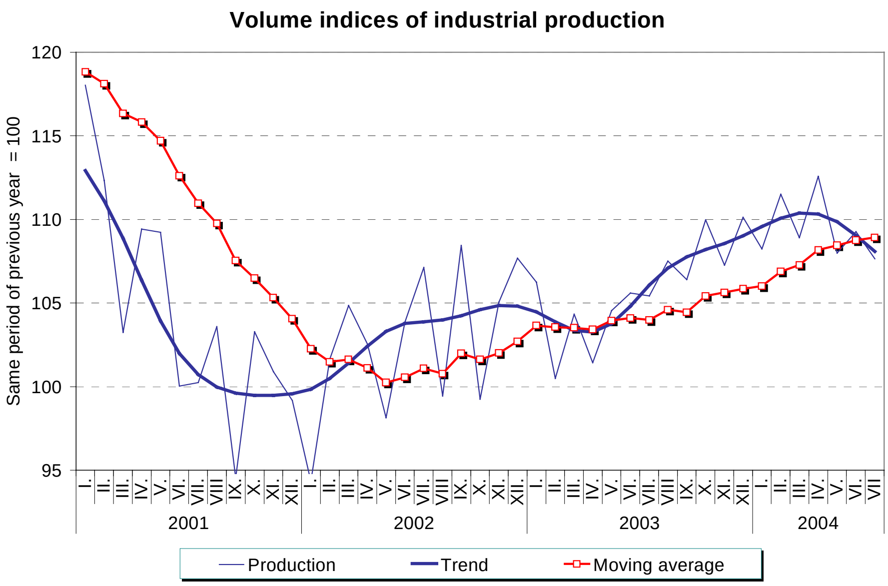
The structure of imports is sound.

The **structure of imports** was also dominated by machinery importation: with its 22% volume growth, it represented over half of import expansion. Within machinery, the import of electrical machinery, appliances and road vehicles and parts produced a significant growth. The 16% increase of manufactured products corresponded to one third of the total import growth. Even though the import volume of fuels did not increase, their Forint price level was up by 5%. The importation of food products and beverages grew significantly (by 28%), but due to its low share (4%) it barely increased our imports. Based on the commodity structure of imports, import growth is likely to have served primarily export and investment purposes.

In terms of country groups: export growth was dominated by the 16.4% increase of exports into the EU; import from this region increased somewhat more moderately by 14.8%. Trade with non-EU countries expanded at a higher-than-average rate, exports growing by approx. 25%, imports by 26%. The increase of the trade balance deficit was generated in this region.

2.2 Production

The growth of **industrial** production was also spurred by the favourable economic trends in external markets. In the first six months, production increased by 9.5% over the corresponding period of the previous year, that of manufacturing companies by 11.5%, their export sales up on the previous year by 19%. In July, production growth declined, which may be related to the summer holiday season.



Between January-July, the productivity of industrial companies increased by 12.5%, which was to a smaller extent attributable to the 2.4% staff cuts.

Domestic industrial producer prices were influenced by higher world market input prices.

Domestic industrial producer prices showed a 9.4% year-on-year growth in July 2004, and they were 8.4% higher on average in the first seven months than in the corresponding period of the previous year. The increase was especially marked in the energy producer branches. The price index of industries producing durable consumer goods was low. In the case of industries producing capital goods, the price increase was attributable mostly to cyclical reasons and world market prices. In aggregate, an average price increase significantly higher than in 2003 should be expected for this year, taking into consideration international price trends and domestic business cycle forecasts.

The price index of export sales, in Forint terms, was 97.4% in July. The strengthening of the Forint over the euro and the dollar reduced the increase of industrial export prices.

Industrial growth is driven by export sales.

As domestic sales stagnated, production expansion was facilitated by the continuing intensive demand increase on external markets. Of the leading industrial branches, the manufacture of electrical and optical equipment increased export sales by 30%, in addition to a 17% growth in its domestic sales. Of its products, the most dynamic growth was seen in the exports of communications products. On the other hand, it is unfavourable that the export prices of the branch were even lower in July than the depressed prices of last year. The export sales of the manufacture of transport equipment was up by 13%, while its domestic sales, which have a mere 8% in its total sales, declined by 9%. Within the manufacture of foods products, beverages and tobacco, the manufacture of food products declined by 2%, and that of tobacco products by over 40%. The latter is due to the exit of some of the large multinational companies from Hungary. The domestic sales of the sector continued to decline (-6%), while its exports expanded by a similar percentage. The most popular export products were processed meat products and non-alcoholic beverages.

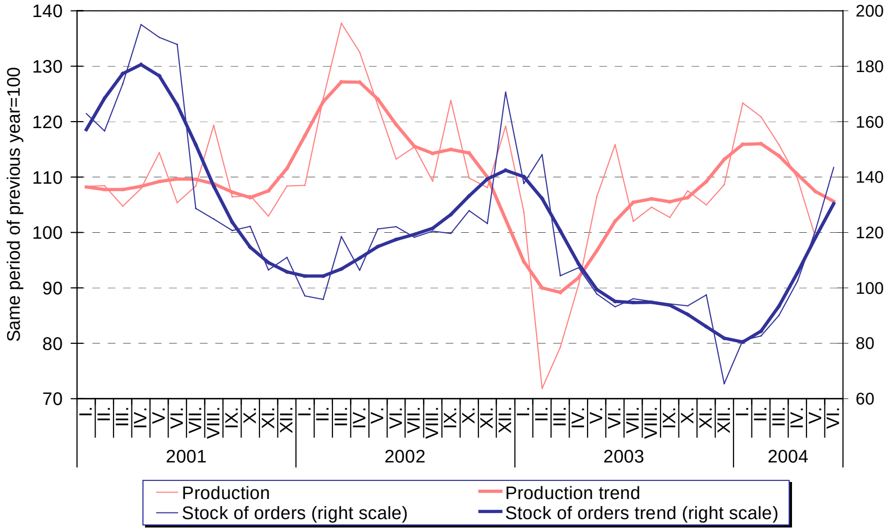
In July, the aggregate **order book** of the highlighted branches increased by 17%, their new orders by 14.5%. In both cases, export destinations produced a dynamic growth, at 20 and 17%, respectively, but the domestic order book is also encouraging.

Industrial output growth of 8–10 % is expected for the whole of the year.

Trends developed in accordance with our expectations, as we had reckoned with the base effect of the growth of the industrial production in the second half of last year. Accordingly, we expect industrial production growth to be around 8-10% in 2004.

In the course of the year, except for May, the output of **construction** increased continuously. However, due to the outstanding growth rate of last June and the retroactive organisational reclassifications, the growth rate published so far until the first half of the year declined significantly, resulting in a growth of 7.6% between January and June. The increment was produced by the almost 15% growth in the building of complete constructions. Building installation stagnated, while building completion dropped by 1.2%. Mostly as a result of the contracts concluded for motorway construction, the volume of new orders doubled.

Volume indices of production and stock of orders in construction



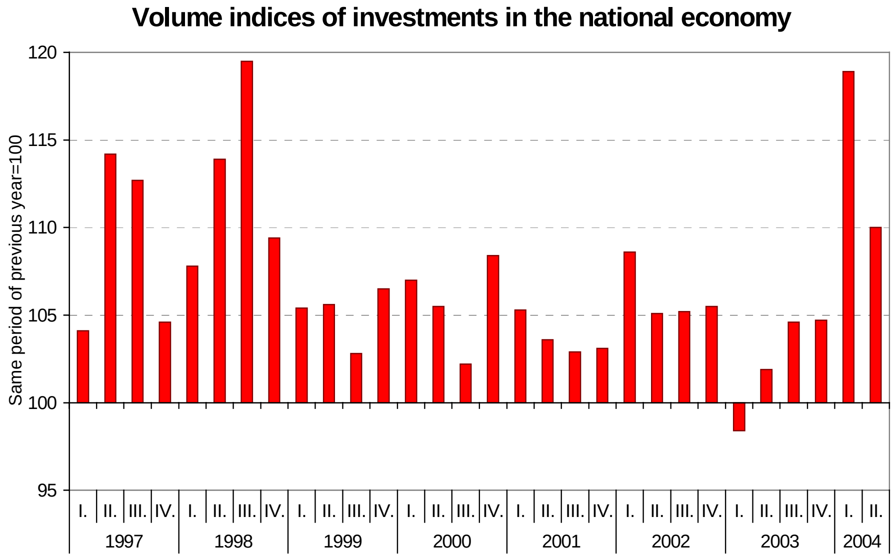
In the construction sector, the cost based price index gradually declined since December 2003, due to demand factors, therefore in June it produced an increase of 3.8%, and as an average of the first six months, 5.1%, over the corresponding period of the previous year.

The growth of the order book may lay the foundations for the continued steady growth of output, but, similarly to the manufacturing industry, the output of the construction sector also started growing dynamically in the second half of last year, and the combination of these two factors render an approximately 5% output growth probable for this year.

2.3 Investments

Investment activity continues to be dynamic.

The volume of investments in the national economy showed a significant increase of 13.5% in the first half of 2004. In Q2, investment activity was 10% higher than one year before, while according to the seasonally adjusted index it declined by 3.6% as compared to the first three months, primarily due to the outstandingly high first quarter output values.

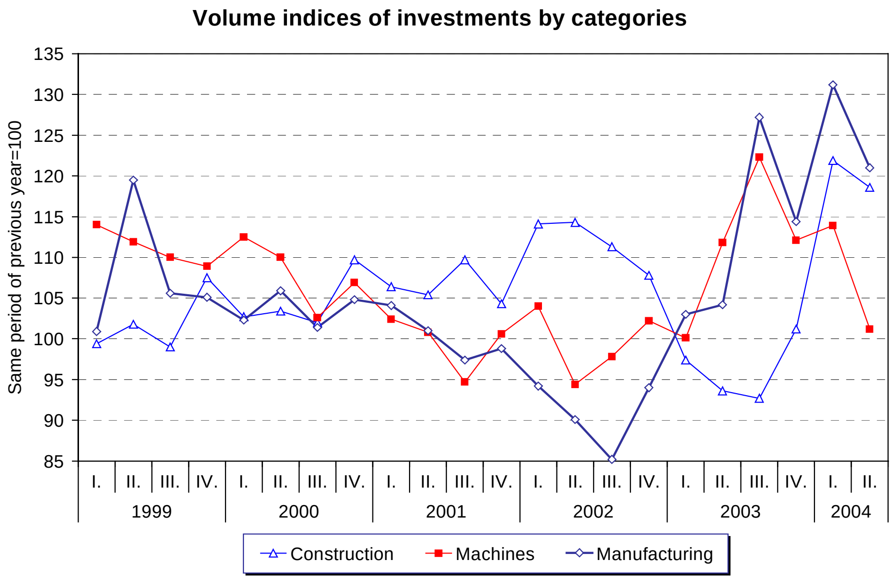


Construction …

The structure of investments showed some change in the second quarter. The growth rate of construction investments continued to be around 20%, while the growth of investment in machinery came to a halt (1.2%). The latter may have resulted partly from a drastic drop in agricultural investments.

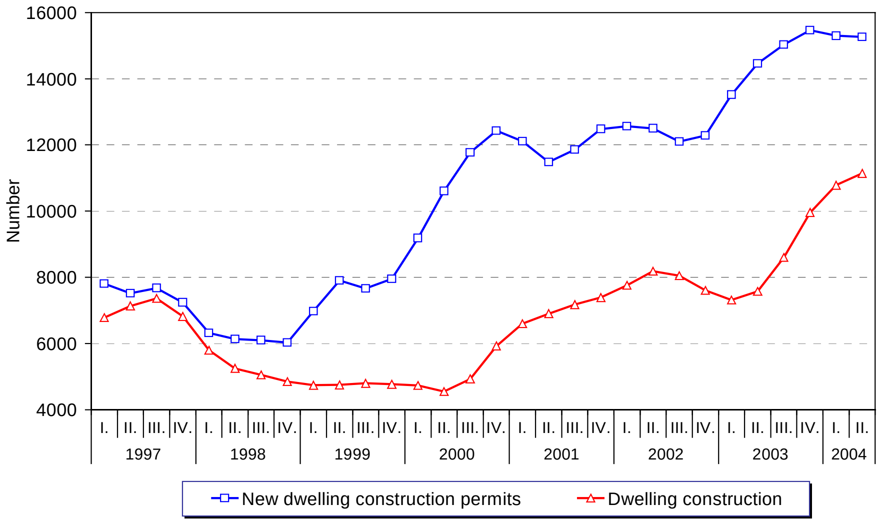
… and manufacturing are leading sectors.

Investments in manufacturing, which are indispensable for the acceleration of economic growth, showed an extreme dynamic growth of 21%, continuing the trend of previous quarters. There was also a significant increase in the real estate activities section (30%), explained mostly by the dwelling construction boom. In contrast, in the field of transport, which also includes road construction, stagnation was registered during the quarter. The branches of public administration recorded only a slight decline, in contrast with the two-digit drop of the previous period.



During the first half of this year, the number of dwellings put to use increased by almost 50%, that of new construction permits issued, by 6%. However, the close to 50% growth rate will slow down significantly in the second half-year, and in the whole of the year the number of dwellings put to use may grow by some 15%.

Dwelling construction and construction permits
(trend cycle data)



The more dynamic development of construction output in the first half-year justifies the slight upward adjustment of the 7-9% forecast in our flash report of June. In the whole of 2004, the volume growth of investments in the national economy is expected to be around 8-10%.

Growth is stronger than expected.

2.4 Employment and unemployment

According to the institutional statistics of the CSO, the number of persons employed by enterprises with at least five employees, and by budgetary and social security institutions increased by 1% in the first half of 2004, therefore in this period an average of 2 million 784 thousand persons were in employment. Within this, the headcount of the business sector increased by 1.5%, that of the budgetary sector declined by 1%. The favourable change in the business sector was attributable primarily to economic recovery, and it is expected to continue during the entire year, while the staffing level of the public sector will be even lower up to the end of the year than it was last year, due to the streamlining implemented in the fourth quarter of last year.

The structure of employment growth was favourable.

According to the labour force survey of the CSO, there were 3 million 894 thousand persons in employment and 244 thousand unemployed on the labour market in February-July 2004. The number of the economically active was 30 thousand down from the corresponding period of last year. On the other hand, the number of the economically inactive did not change, thus in effect the number of persons in the 15-74 age cohort declined by 30 thousand. The employment rate of the first seven months deteriorated by 0.3 percentage points (50.4%) since the corresponding period of 2003, which results from the aforementioned drop in the number of the employed. The results of the CSO labour force survey should be treated with some caution, taking into consideration the reliability of sampling, therefore in our view the employment growth reflected in the institutional statistics gives a truer picture of the economic trends.

Labour market indicators produced no substantive change.

The unemployment rate of the 15-74 age group was 6% on average in the first seven months of 2004, and our annual forecast reckons with a similar figure. This year the number of employed persons may increase slightly on the level of the national economy. As a result of these processes, both the employment and the participation rates may increase only slightly.

2.5 Wages and earnings

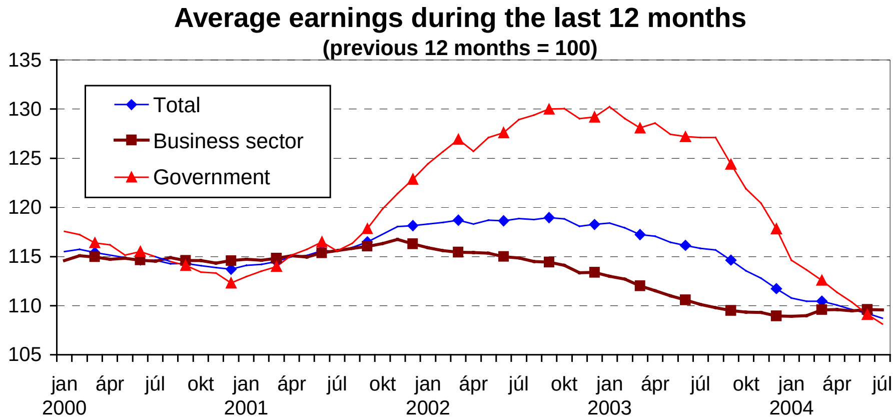
Gross wage growth slowed down.

For purposes of the sustainability of the growth path of the economy, the maintenance of the equilibrium and the harnessing of inflation, the moderate rate of wage growth has outstanding importance. According to the Convergence programme, balanced growth can be attained given an annual average gross earnings increase of 7.4% per annum. In contrast, the nominal monthly gross average earnings of full-time employees increased by 8.6% nationally in the first seven months of 2004 according to CSO figures, of which the business sector (in enterprises with at least five employees) produced a growth in excess of the national average, at 9.8%, which went hand in hand with a substantial (1.5%) increase in the number of employees, while in the budgetary sector the gross average earnings was 6.8% higher than in the first seven months of 2003. On the other hand, the annual growth of net earnings was approximately 1-2 percentage points lower than that of gross earnings, as indicated by preliminary calculations.

Monthly average earnings
in the first seven months of 2003 and 2004
the first quarter of the previous year = 100 (in per cent)

	Total		Business sector		Government	
	2003	2004	2003	2004	2003	2004
Gross average earnings	114,1	108,6	108,7	109,8	124,9	106,8
Net average earnings	118,1	107,3	114,5	108,0	125,1	106,3
Real earnings	113,1	100,2	109,7	100,8	119,8	99,3
Number of employees	101,0	100,9	99,8	101,5	103,6	99, 0

Due to its headcount, the business sector represent a greater weight in the increase of national average earnings, therefore the fluctuations of the earnings growth in the business sector were barely offset by the stable earnings indicators of the budgetary sector. In the entire business sector, gross average earnings increased by 10.1%, so far 2 percentage points faster than expected, in January-June 2004. This growth slowed in July by 0.3 percentage points to 8.8%, as the year-on-year growth in July was only 8%. The growth rate seen in the second quarter was more modest than in the first quarter, because of the payment of the bonuses having been moved from May to March. Without the distorting effect in March, and incorporating it into the May figure, the two quarters show no effective difference.



Economic units employing at least 5 persons.
Source: CSO

Wage increase in business sector barely higher than NICC recommendation.

The faster-than-expected change in the average earnings of the business sector in the first half-year may be related to improved efficiency and to the recovery of the service sector. In the branches of the manufacturing sector, gross earnings were consistently around the business sector average, with very little deviation. According to the twelve-month gross earnings index of the business sector, growth bottomed out in January-February, to be followed by a slow upward movement, but we expect this growth rate to be reduced from the second half of this year. In January and February minimum wage increases have the greatest effect on the wage increases in the business sector. There, wage increases are generally implemented between March and May, therefore the time series show a slight growth from that point on. We continue to expect more modest annual gross earnings growth than in the first half-year, forecasted to be somewhat higher than the 7-8% recommendation of the National Interest Conciliation Council in the 9-9.5% range.

Significant slow-down in the budget sector as well.

In the first half-year gross average earnings increased by 6.3% in the budgetary sector. Earnings growth accelerated slightly in July, thus the average for the first seven months went up to 6.8%. Even so, the growth rate of the gross earnings in the sector obviously slowed down considerably in 2004 as compared to the corresponding period of 2003. The slow-down is attributable to budgetary austerity measures. The slower growth has multiple positive effects on the economy, as the pressure on the wages in the business sector disappeared (professional wage race), while wage-type payments within budgetary expenditures increased at a rate below inflation. On the other hand, factors underlying the July increase include the 6.4% increase of wage supplements for public servants (which represents only 0.6% in the index), and the 4-6% wage increases of local governments, in some cases retroactive to January.

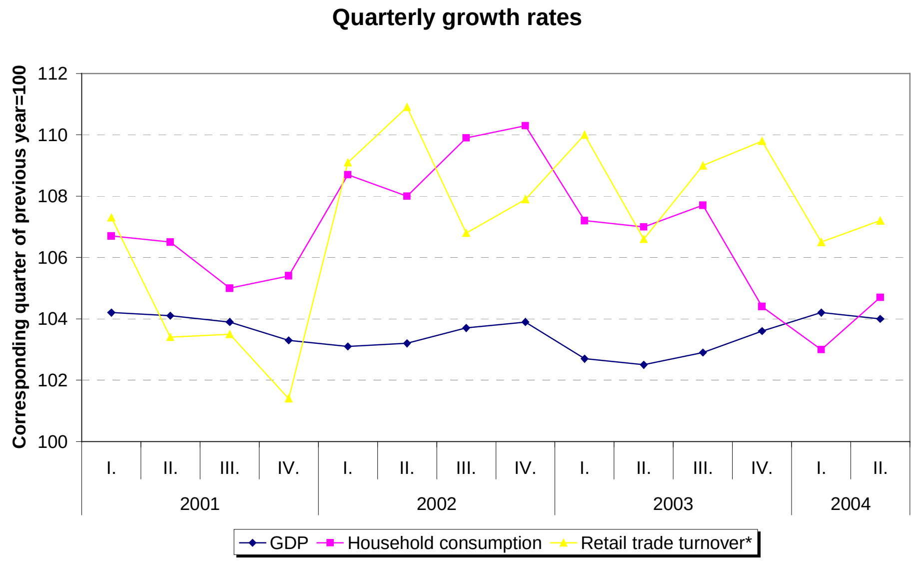
In 2004, we project an 8-8.5% earnings growth in the national economy. The figure for the business sector will be higher (9-9.5%), that for budgetary institutions is expected to be around 6%. The increase of national real wages is expected in the 0-1% range in net terms due to higher taxation and the moderate wage increases in the budgetary sector.

Real wages in the national economy will slightly be higher than last year.

2.6 Consumption, retail trade

According to the CSO figures, the growth rate of **household consumption** accelerated in Q2, thus it is barely below GDP growth for the entire half-year. We should note, however, that in the quarterly GDP calculations the CSO estimates household consumption from retail trade and household statistical figures, therefore the consumption increase is not underpinned at this point from the income side.

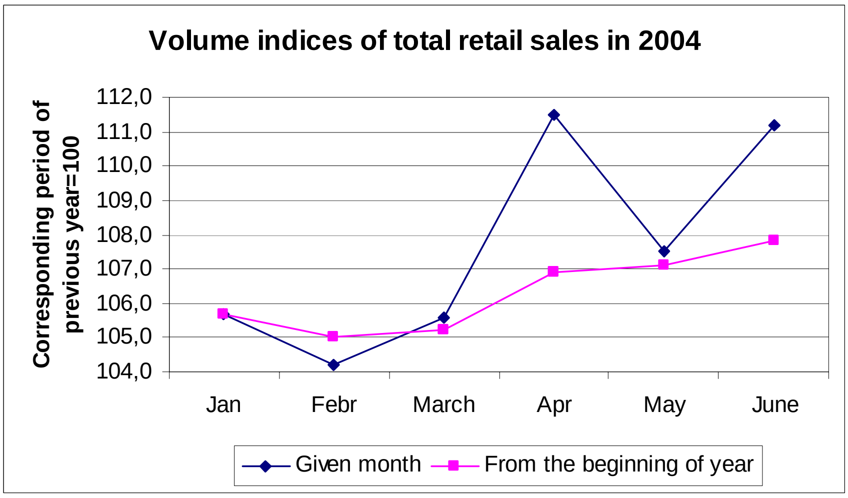
The growth rate of consumption temporarily accelerated in Q2.



* Without motor vehicles and automotive fuel, adjusted for calendar effects

The volume growth of **retail trade turnover** also accelerated in the second quarter. The sales volume adjusted for calendar effects, without the trade of motor vehicles and automotive fuel, was 6.5%, 7.2% and 8.8% higher on a year-on-year basis in the first quarter, second quarter and the entire half-year, respectively. The sales of food, beverages and tobacco went up by 3.5% in the first six months, that of non-food products, by 12.3%.

The volume of the total unadjusted retail trade turnover exceeded the level in the first half of the previous year by 7.8%:



The growth of total turnover during the half-year was extremely hectic: the monthly growth rates varied in a wide band, which was caused primarily by the fluctuations in motor vehicle sales because of the uncertainties around the registration tax.

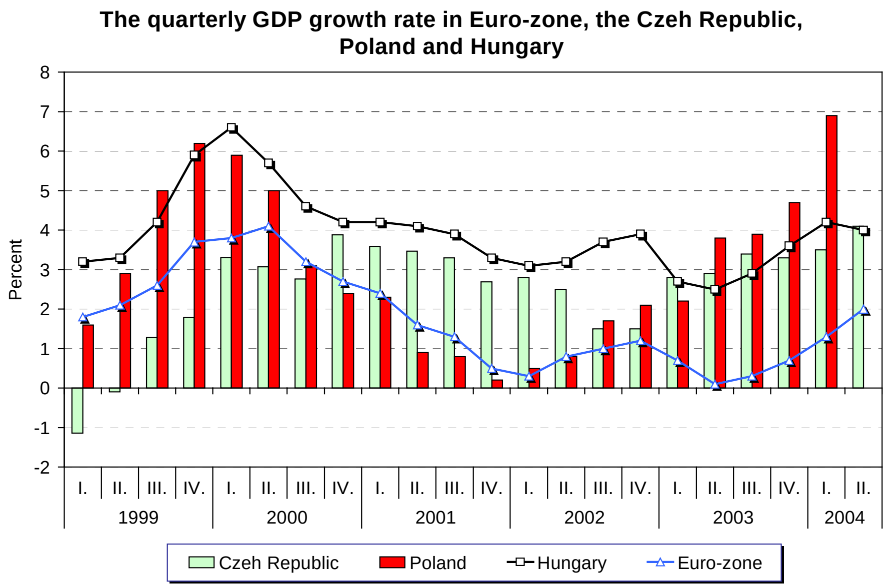
Based on income and savings figures and forecasts, in the remaining part of the year we expect consumption growth to slow down. For the entire year, a household consumption growth of 2.5-3% is to be expected, considerably lower than in the previous year.

For the entire year, considerably lower consumption growth is expected than last year.

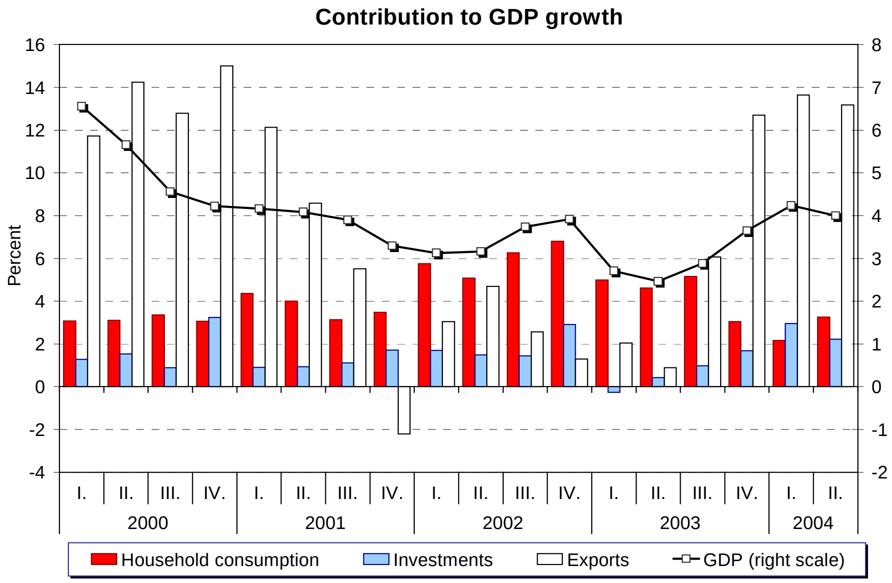
2.7 Gross domestic product

The gross domestic product increased by 4% in Q2 and by 4.1% in Q1. The improved external economic environment, particularly the acceleration of growth in countries important for Hungarian exports has significant influence to growth.

GDP growth continues to be robust.



Exports and investments became the main driving forces of growth, but in the second quarter the contribution of consumption also increased.



In the first half-year, **household consumption expenditure** increased at a higher rate than expected (4.4%). The acceleration in the second quarter is explained by the substantial motor vehicle purchases due to the introduction of the registration tax. After adjusting real processes for this one-off factor, consumption expenditure showed a similar growth in the first and second quarters. Data available on the income side (real wage growth slow-down, increase of household savings) also fail to support any runaway consumption.

Due to substantial investment activity…

All three sectors contributed significantly to the dynamic growth of gross **fixed capital formation** in the first half-year (13.5%). The investment activity of businesses and, within that, the largest category of manufacturing investments showed a high growth. Considerable upswing was perceived both in household investments (dwelling construction) and in general government investments (motorways). In the second half of the year we expect the high growth rate to decline slightly (6-7%), which is justified by the high base.

… and the dynamic export expansion …

In **foreign trade**, due to the rise in imports (pre-purchases relating to EU accession, see Chapter 2.1.), net exports considerably slowed down GDP growth (-2.6%), despite the higher-than-expected export growth. In the second half-year, however, we expect export to grow in excess of import, which is supported by the July foreign trade figures.

In the first quarter, the **production-side** structure of GDP showed no significant change since the preceding three months. The value added by production sectors and by services both increased dynamically (by 5.7% and 3.7%, respectively).

… growth will be faster than forecasted.

On the whole, dynamic economic growth is to be expected for the whole year both on the production and use sides. Consequently, based on the half-year developments, we have implemented an upward adjustment on the 3.5% **GDP growth** forecast for the whole of 2004 in our flash report of June: economic growth may be around 3.8%-3.9% this year.

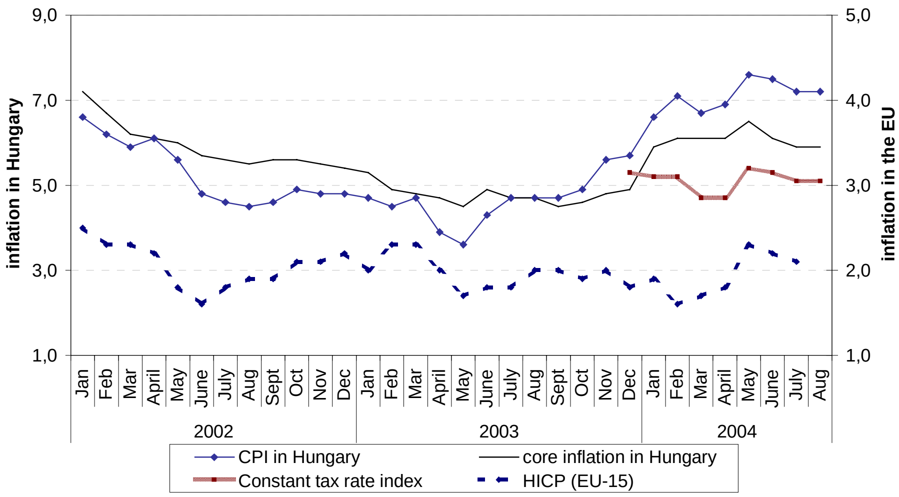
3. Inflation

According to CSO figures, year-on-year inflation was 7.2% in August, and 7.1% in the first eight months of 2004 on average. The trend of inflation was in accordance with expectations, but its rate was higher than forecasted, primarily because of international energy prices.

The trend of inflation is as expected, but is rate is slightly higher.

According to CSO estimates, two fifths of the 4.9% price increase experienced in the first eight months were caused by VAT and excise tax changes. Adjusted for the effects of tax changes, and comparing the indicator to the consumer price index of the previous year we find that inflation growth is attributable to international factors, apart from the carry-over effect of the food price rise of the end of last year.

Inflation trends in Hungary and in the European Union
change in comparison to the same month of the preceding year, per cent



Fundamental economic trends have no inflationary effects, but…

The impact of the price rise on the international commodity and energy markets was noticeable in Hungarian inflation, moving parallel with European trends. This proposition is supported by the fact that the trend of the constant tax rate index shows a similar curve to the price changes in EU Member States. As evidence of the adaptability of the Hungarian economy, the non-planned inflation increment is similar to that of EU Member States.

… international energy and commodity prices increase price levels.

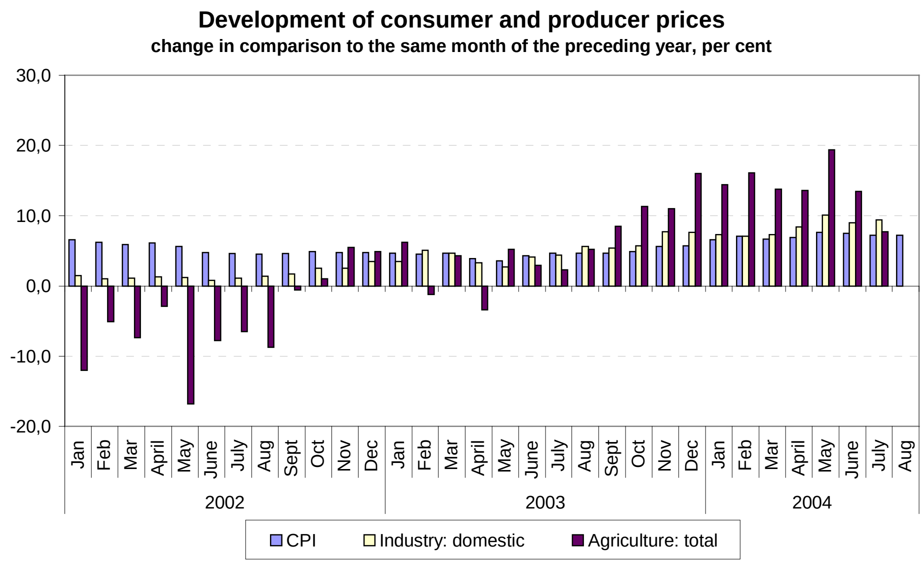
In the second half of the year the effect of the rapid food price increase last autumn and of the increase of indirect tax rates at the beginning of this year will be gradually removed from the indices; therefore, after some stagnation in July-August, the rate of inflation is expected to decline to around 6%, while the annual average inflation is forecasted at around 6.8%.

A marked reduction is expected for the second half of the year.

Because of trends in agriculture and commercial competition, food prices continue to be moderate. Disinflation is most marked in the category of manufactured goods, and the average price level of consumer durables is lower than it was a year before.

Due to the higher-than-expected oil price level and its uncertain trend, besides the changes in the regulation of the excise tax, automotive fuel prices were rather volatile.

The prices of housing-related services produced an increase significantly above the average in part because of the rise of the preferential VAT rate. Fees for market services have continuously increased above the average rate, as demand for them leaves more room for the incorporation of costs into prices. On the other hand, there is price restraining competition on the telecommunications market.



Based on the agricultural price tends of the first half-year, no inflationary pressure is foreseen to arise from the agricultural sector, given the good crop expectations and also taking into consideration the price rise of slaughter animals. In future, the Common agricultural policy is expected to influence prices towards a more stable level, also reducing their inflationary effects. The current rise of domestic producer prices presents only a limited inflationary factor in the environment of keen import competition, even if international economic trends entail the increase of import prices.

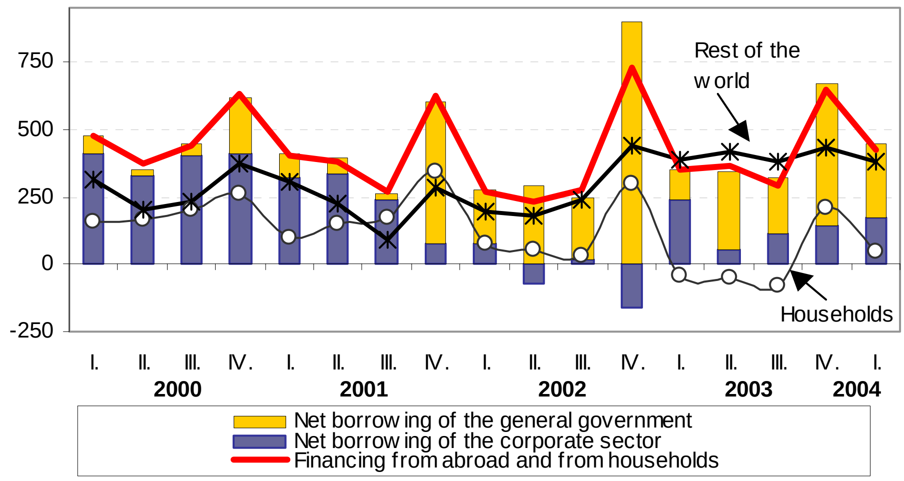
4. Income and financial processes, equilibrium

4.1 Equilibrium

External financing is still high …

As seen from the financial accounts, the external financing requirement of the economy in the first quarter of 2004 maintained the high level that emerged in Q4 2002 (8.7% of the quarterly GDP). As in the previous year, the significant external financing was related to the financing requirement of the corporate sector and the general government. The general government deficit during the year moved unevenly, most of it generated in the first half-year. Financial accounts indicate that the net financing requirement of the general government corresponded to 5.9% of GDP in Q1 2004. The upswing in investments necessarily entails the increase of the net borrowing requirement of the corporate sector (financial and non-financial corporations together: 3.8% of GDP). The financing requirement of the general government and of corporations, however, is to some extent offset by the fact that households, due to a fall in borrowing, were in a net saving position again in the first quarter of 2004 (1% of GDP).

Financing requirement / capacity of sectors (HUF, billion)



The NBH will publish the financial accounts for Q2 only on 1 October, therefore we have only incomplete information available for this period. That information indicates that the external financing requirement of the economy was substantial again in Q2. Investments continued their dynamic growth, which suggests an increased financing requirement of the corporate sector. Based on cash-flow data, the central government deficit was almost one and a half times its Q1 level. The combined financing requirement of general government and corporations could have been counterbalanced to some extent by the net saving position of households, just as in the first quarter.

… but its underlying structure has moved in a favourable direction.

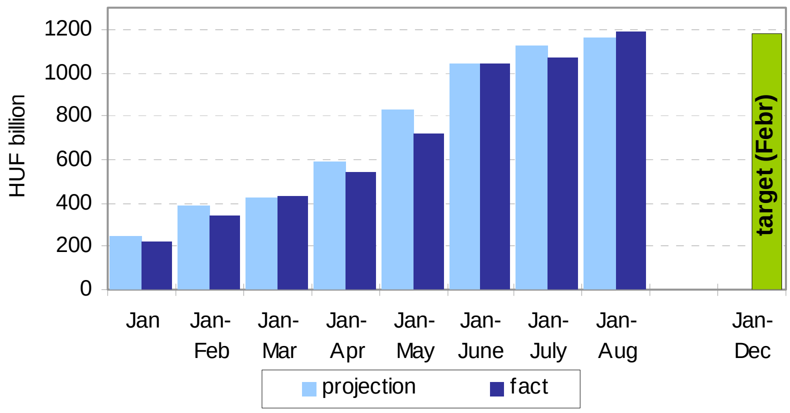
In view of our investment forecast, adjusted upwards since the previous Flash Report, and the downside risks of our current account forecast, we expect for the entire year the external financing requirement of the economy to fall less markedly than previously expected, by 0.5-1 percentage point of GDP below the 2003 level. Our forecast reckons with EU transfers also improving the external equilibrium indicator through the capital account in the second half of the year. In light of the first quarter facts and the second quarter preliminary information, we modified upwards our forecast for household savings to around 1% of GDP. The growth of the general government deficit will be considerably slower in the remaining part of the year. According to the reviewed forecast, the deficit will be 5-5.3% of GDP in 2004, rather than the previously expected 4.6%, but even so, it will improve by about 1 percentage point over the 2003 year figure. The internal structure of the external financing requirement has moved in a more favourable direction since the previous years. The growth of household savings and the declining financing requirement of the general government allows for more extensive financing of corporations, even against the background of a slight improvement of the external equilibrium.

4.2 General Government

In light of the 8-month figures, the deficit forecast has been amended.

The figures of the first eight months called for a review of the **general government** deficit forecast. The modification of the forecast of 5-5.3% of GDP, which is close to the expectations of the market, instead of the target set at 4.6% of GDP in February for the ESA95 deficit, contributed to the strengthening of confidence. Until July, based on cash flow figures, the deficit (without local governments) generally produced better results than the forecasts updated on a monthly basis. The HUF 120 billion deficit of August, however, was HUF 26 billion higher than expected, thus the deficit reached HUF 1192.3 billion by the end of the first eight months (the target set in February was HUF 1184.7 billion). The worsened position is explained mostly by the greater deficit of the central budget (HUF 926.8 billion), while the balance of the social security funds is slightly worse (HUF 301.4 billion deficit), that of the extra-budgetary funds (HUF 35.9 billion surplus) is somewhat better than expected.

Government deficit in 2004



The greater deficit was not caused by expenditure overruns, …

In the first half-year the deficit rose sharply. In the first quarter over one third, and by the end of the half-year almost 88% of the cash flow deficit corresponding to the 4.6% ESA deficit had been generated. The forecast for the annual development had reckoned with this, taking into consideration the additional payments due in the first half-year (13^{th} month wages, instalment on the Grippen airplanes, 53^{rd} week pensions, financing advances, interest expenditures, etc.), and the expected revenue shortfalls (loss of VAT after accession, PIT refunds due to tax allowances). By the end of August, 66.4% of expenditures had been made and 61.6% of revenues had been collected. Thus the level of the deficit is attributable to revenue-side developments rather the expenditure “overruns”, as the latter effectively correspond to the proportionate, eight-month portion of the annual amount.

The increase of the tax, tax-type and contribution revenues of the central budget and the social security founds was below 2% as compared to the January-August period of 2003. Of the largest revenue items, only some 1 percentage point less of social contribution income was collected than proportionately budgeted for the eight months, but the shortfall in personal income tax was greater. Of this tax, the central budget collected almost 6 percentage points less in the eight months than the time proportionate amount (in January-August 2003 the difference was less than 3 percentage points). Furthermore, the revenues from excises and consumption (registration) tax was also 6.5 percentage points less than the time proportionate amount. The shortfall in the value added tax (more than 10 percentage points) is even more substantial, most of which is related to the loss of import VAT revenues after accession. Partly due to this, and partly because of the high base attributable to the changes in the refund procedures last year, the net VAT revenue collected by the budget is some HUF 150 billion less than in January-August 2003.

… but by shortfalls in tax receipts.

The 8-month figures clearly outline the risks indicative of a deficit greater than the annual target set in February. The greater-than-expected shortfall of VAT revenues after the accession, the more extensive use of tax allowances in the personal income tax, and the shortfall of the excise and registration taxes foreshadow revenues approximately 0.7% of GDP lower than forecasted in February. This shortfall is somewhat offset by the expected surplus in the corporate income tax, simplified business tax and the fees and social contribution payments.

At the end of August, overall expenditures were effectively at their time proportionate level, but for the entire year the excess of pension payments, linked to wages and inflation, as well as of pharmaceutical subsidies, housing subsidies and transfers to disabled persons may reach 0.3% of GDP.

Having reviewed the trends in general government, the Government, in order to curb the growth of the deficit, decided on immediate measures to improve the equilibrium (sale of treasury property, collection of dividends from state-owned enterprises, prevention of the spending of surplus revenues of extra-budgetary funds, tighter tax and excise controls at the borders). The use of appropriation residuals of budgetary institutions and chapter-managed appropriations may also present a risk of increasing the deficit, even after the freezing of appropriations at the beginning of the year. Therefore the Government adopted a decision to prevent the reduction of the stock of residuals.

After the measures to improve the equilibrium…

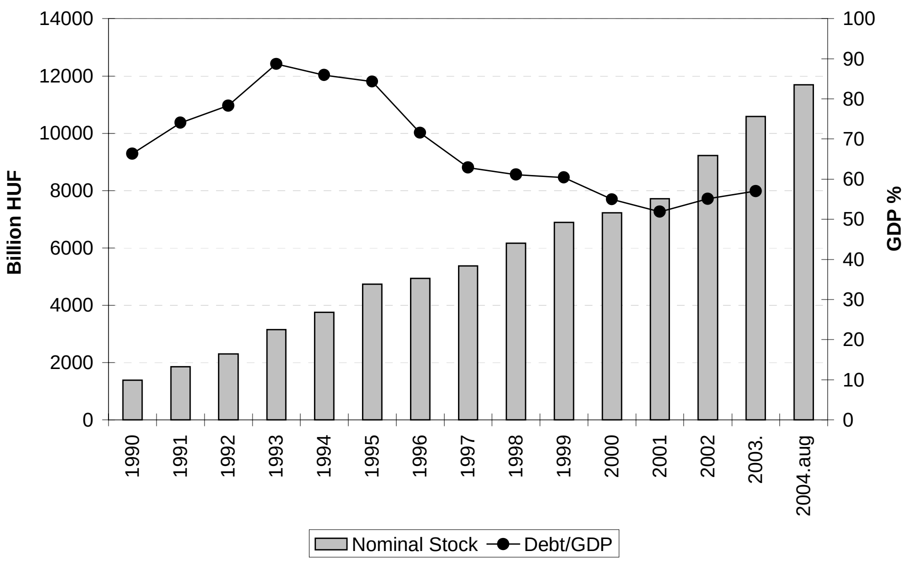
Taking into consideration the revenue and expenditure-side trends and measures, the cash-based deficit of the central government is expected to be 6.3-6.5% of GDP. Including a risk in the balance of local governments, corresponding to approx. 0.2% of the GDP, the ESA95 deficit of the general government may be 5-5.3% of GDP. The adjustment implemented in general government this year is significant,

… the expected deficit is 5-5.3% of GDP, cca. 1 percentage point less than last year.

even taking into consideration the higher forecast. After the ESA deficit 6.2% of GDP in 2003, the improvement in the equilibrium this year will come close to 1% of the GDP, and in the best-case scenario it will actually reach that level; the magnitude of the adjustment is among the largest in the countries subject to the EDP. Primary balance will improve even more, as the interest balance deteriorates by approximately 0.2% of the GDP as compared to 2003.

On 31st December 2003, the gross public debt was 57% on cash basis (59.1% under ESA 95) relative to GDP.

Central Government Gross Debt (on cash basis)



Slightly growing debt ratio in 2004.

24% of the total debt was denominated in FX, 76% was denominated in HUF. By the end of August 2004, the stock of debt increased by HUF 1105.5 billion, or 10.4%. By the end of 2004, gross debt may change as a function of the budget deficit, privatisation receipts and exchange rate changes. Reversing the trend of previous years, the ratio of foreign currency denominated debt has increased in 2004, as it provides funding at better conditions than Forint financing does. The detailed structure of the public debt is presented in the table below:

(billion HUF)

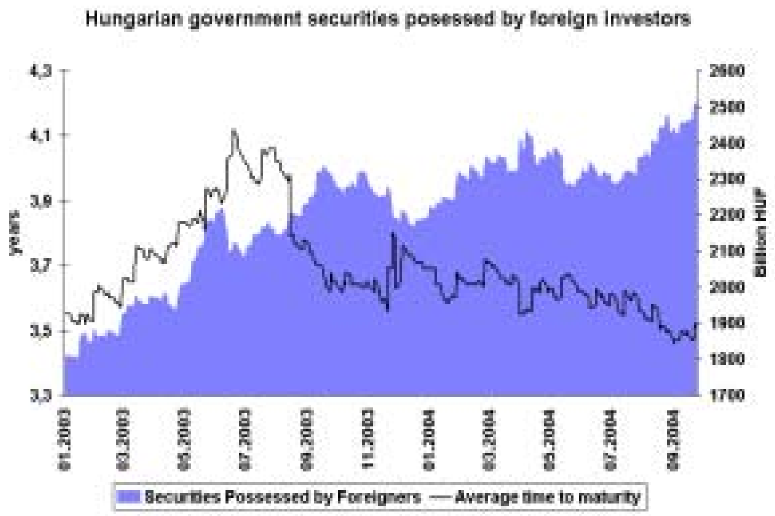
	2003		2004		Change	
	December	**%**	**August**	**%**	**billion HUF**	**%**
FX debt	***2 579,0***	***24,4%***	***2 923,1***	***25,0%***	***344,1***	***13,3%***
Government securities	1 494,9	14,1%	1 826,9	15,6%	332,0	22,2%
Loan (marketable)	617,6	5,8%	654,3	5,6%	36,8	6,0%
NBH loan	466,5	4,4%	441,9	3,8%	-24,6	-5,3%
HUF debt	***8 008,7***	***75,6%***	***8 770,0***	***75,0%***	***761,3***	***9,5%***
Government securities	7 890,8	74,5%	8 668,8	74,1%	778,0	9,9%
Loan (marketable)	46,7	0,4%	55,1	0,5%	8,4	18,0%
NBH loan	71,2	0,7%	46,1	0,4%	-25,1	-35,3%
Total	***10 587,7***	***100,0%***	***11 693,1***	***100,0%***	***1 105,5***	***10,4%***

Since the last Flash Report (15 June 2004), yields declined, at a moderate rate initially, then, responding to expectations for an interest rate cut, substantially. As a result of the uncertainty of late August, the yield curve moved slightly upwards (see Chapter 5.3, Figure 3). For the entire year, yields dropped considerably for short term maturities, while, for longer terms, yields increased modestly for the 3-year term and more markedly for the 5, 10 and 15 year maturities. (However, yields for all maturities were significantly higher in the first eight months of this year than in the corresponding period of last year.) For foreign currency financing, the interest rate differential decreased by 15 basis points since the beginning of the year. The interest rate differentials on foreign currency funding were also more favourable than in the first two-thirds of the previous year.

Demand at the discount treasury bill and government bond auctions was moderate (with coverage of 1.7-4.0 and 1.2-1.4, respectively) for the period on average (mid-June – early September). At the auctions of liquidity discount treasury bills, demand was initially moderate, and at the end of the period, weak.

The stock of government securities owned by non-residents increased.

In the period since the last flash report, demand of non-residents for government securities denominated in HUF varied. Early in the period there was no substantial demand for Forint denominated government papers from foreigners, and the stock of their holdings declined somewhat. From end-July, however, their holdings increased sharply, to be followed by a decline in early September. Thus in the whole period the stock of government securities owned by foreigners increased by HUF 104 billion in total, which, taking into consideration the yields paid, represents a smaller additional financing. Meanwhile, the average term to maturity of the stock declined slightly.

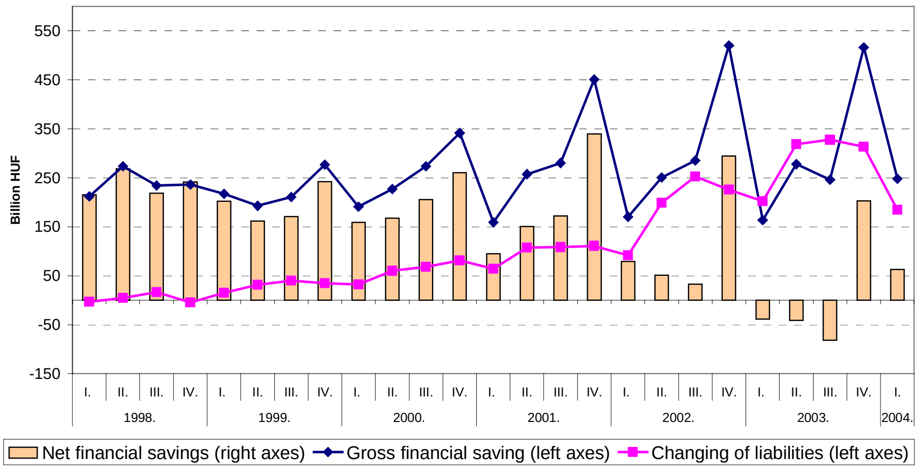


4.3 Households

The financing position of households improved significantly.

In the first quarter of 2004[4] the net financing position of households was positive again, similarly to the last quarter of 2003. The financing capacity of the sector amounted to HUF 48.4 billion in the quarter, which, due to seasonal effects, was considerably below the previous quarter figure, but it is a significant year-on-year improvement.

Development of the financial position of households
from 1998 (new methodology, transactions)



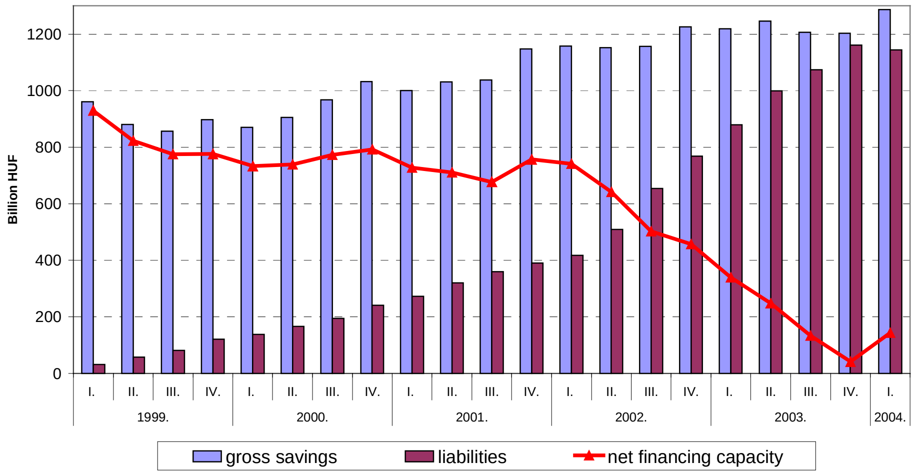
Due to seasonal effects, the first half of the year is the period when the net financing capacity of the sector is lower because of the more modest growth of gross financial savings. This phenomenon was present in 2004 as well. The first quarter level of gross savings, at HUF 232.8 billion, is more or less in line with the seasonally expected figure.

In Q1 2004, like in the previous quarter, the net borrowing of households was reduced, but its value remains high. The decline is attributable mostly to the tightening of the terms of government subsidised housing loans in December 2003. During the period, the portfolio of stock of borrowing of households increased by HUF 184.5 billion, household loans representing 120 billion HUF of that growth. This has been the lowest growth since Q1 2002 for the total debt stock, and since Q4 2002 for housing loans.

As a result of the low borrowing, the declining trend of the annual net financing capacity, present for two years continuously, has come to a halt. This is indicated by the fact that the 12-month financing capacity of the sector was HUF 128.4 billion in Q1 2004, that is, its value almost tripled over the previous quarter figure.

[4] The most recent household savings figures are for Q1 2004.

Net financing capacity of households (12 month accumulated figures)



In Q2, the net saving positonis expected to improve further…

According to preliminary figures, the borrowing of households for housing purposes continued to decrease in Q2 2004, though at a slower rate than in the previous quarter, while the share of foreign currency denominated property loans increased. The declining borrowing of households, supplemented by the high yields conducive to the growth of their savings as well as non-recurring items such as the payment of the approx. HUF 35 billion 53rd week pension in May, results in the improvement of the net saving position of households.

Preliminary data show that the 12-month financing capacity of households, having continued its increase in the second quarter, was HUF 140-150 billion in the first half of 2004, which was attributable primarily to the declining borrowing of the sector.

In the first half of 2004, the value of the government securities holdings of households increased by HUF 144 billion, increasing the share of the sector in the government securities market by 0.9 percentage point, to almost 14%. In contrast, the equity sales of households exceeded their purchases by HUF 17.9 billion, but due to the HUF 36.6 billion capital gains realised during the period the equity portfolio of the sector increased in aggregate by HUF 18.7 billion. Despite this growth, as a result of the fast rise of stock prices, at the end of June only 4.4% of listed equities were directly owned by households, which is 0.4 percentage points lower than at the end of 2003. The stock of the investment units held by the sector declined by HUF 105.9 billion at market price in Q1, while in Q2, it increased by HUF 28.1 billion, therefore the share of households in the ownership of these financial instruments declined by 4 percentage points to 70.6 percent in the first half of 2004.

…and for the whole year, it may be around 1% of GDP.

Owing to seasonal effects (the growth of disposable income), the growth of the gross savings of households is expected to accelerate in the second half of the year, while, due to the projected expansion of foreign currency denominated real estate loans, the liabilities of the sector will also increase at a rate faster than in the first half-year. Accordingly, taking into consideration the declining level of borrowing during the entire year and the high yields encouraging savings, in the whole of 2004 the net financing position of the sector is expected to be around 1% of GDP.

4.4 Corporate sector[5]

IN the first half-year the ecnomic upswing resulted in more corporate borrowing…

During the first half-year, enterprises raised external funding, both domestically and internationally, at an increasing extent to finance the upswing of their investment and export activities. The external financing amounted to almost HUF 830 billion even as indicated by the incomplete set of data currently available. **Domestic banks** financed the corporate sector with HUF 430 billion of net lending, of which the share of non-financial corporations was HUF 240 billion. This corresponds to a portfolio increase of 16% over the first half of the previous year in the case of non-financial corporations, while in the case of other financial corporations, the increase of the net borrowing from banks exceeded 100%. When analysing these conspicuous differences in the growth rates, we must take into consideration the highly different sizes of the portfolios: the net borrowings of non-financial corporations at end-June 2004 were HUF 2 270 billion, while those of other financial corporations were HUF 936 billion. Furthermore, it should be noted that the actual domestic bank financing of non-financial corporations is considerably more than what is reflected in direct bank borrowings, because the majority of the inter-company loans extended to mostly bank-owned financial intermediaries (generally through leasing firms and factoring firms) were taken up by non-financial corporations, in addition to households.

…foreign currency loans continue to dominate net borrowing.

In the field of the use of bank financing, there are several notable and, between the two quarters, contrasting phenomena. While in the first quarter non-financial corporations took out net loans of HUF 245 billion, probably to finance import brought forward for the most part, and the net borrowing of other financial corporations was reduced, in the second quarter the corporate sector had net borrowing of HUF 200 billion from the domestic banking system, all of which related to other financial corporations. As a result of the high Forint interest rates, foreign currencies remained predominant (70%) in net borrowing. Even though this dominance is not yet reflected in the debt stock, the process cast doubts on the effectiveness of the interest rate policy of the central bank. During the first half of 2004, the net foreign currency lending of banks was almost twice as much as Forint dominated lending; indeed, in Q2, only the net foreign currency debt of corporations increased (by HUF 300 billion), while their net Forint debt declined by HUF 100 billion. The latter can be attributed in equal shares to the decline of Forint lending and the increase of deposits, while in the case of foreign

[5] Without credit institutions (non-financial + other financial corporations)

currencies, the dynamic growth of the portfolio is mostly due to the expansion of lending.

In April, foreign financing increased again.

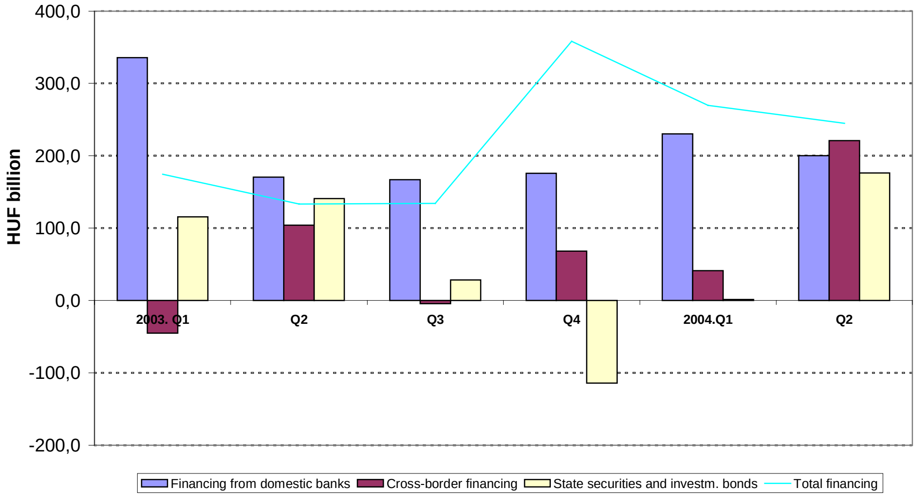
Corporations raised HUF 41 billion of **funds from abroad** to cover their financing requirements in the first quarter. In the first month of the second quarter[6] both net cross-border borrowing and inter-company loans produced an outstanding growth after the decline of the previous months. This, together with the net direct investments steadily expanding during the year, resulted in high foreign financing figures of almost HUF 180 billion in April. Thus in the first four months of the year, corporations raised foreign financing of HUF 221 billion in total, which indicates a substantial increase in their financing requirement. The improvement of the business cycle and the intensive investment activities of corporations are likely to keep foreign financing at a high level, and within that, the high activity of non-residents in direct investments may also continue.

During the first half-year, corporations added HUF 176 billion to their **securities** portfolios (government securities + mutual fund shares). The substantial increase of securities claims was caused by the investments of other financial corporations into government securities, mostly in Q2. Mostly insurance companies and pension funds strived to exploit high yields the most by expanding their government securities portfolios by almost HUF 190 billion. Non-financial corporations liquidated not only Forint deposits but also government securities (approx. HUF 30 billion) to cover their financing requirements. Their investment unit portfolio was practically stagnant, while other financial corporations increased their mutual fund shares portfolio by HUF 35 billion, primarily because of the investments of insurance companies.

In the forthcoming months, external demand and domestic trends will in all probability result in the continued increase of corporate financing requirements. If domestic financing continues to be considerably more expensive than external financing because of the exceedingly high Hungarian interest rates, the majority of businesses will continue to prefer external financing, either directly or through banks. This phenomenon will put additional strains on the balance of payments, while the operation of a large segment of corporations will be increasingly removed from the scope of monetary regulation.

[6] In the absence of balance of payments data, no figures are available at this point for the subsequent months.

Corporate sector net financing



4.5 External equilibrium

The current balance deficit continued to deteriorate…

In the first four months, a EUR 2.8 billion net expenditure overrun was generated in the current balance of payments[7], EUR 562 more than in the corresponding period of 2003. 40% of the current balance deterioration of the first four months is attributable to the poor performance of services this year, while approx. 30% to the deterioration of the foreign trade balance.

due to the unfavourable external trade balance for non-recurring reasons …

Based on the January-July 2004 foreign trade figures of the CSO, a substantial current balance deficit is likely to occur in the second quarter, due merely to the high foreign trade deficit. This is partly because of the lag in the processing of export data, but the main factor is soaring imports, which, in addition to the impressive export growth, is attributable to several, non-recurring, technical factors.[8] According to our expectations, which are underpinned by the foreign trade data of July, the deterioration of the foreign trade balance deficit will come to a halt in the second half-year, and it will improve over the base period, as a significant part of the intended purchases (EUR 500-600 million) were already made in the first half-year.

…poor service exports…

The inadequate performance of services in Q1 could not be offset by the April figures, but no further decline occurred. Thus the net expenditure surplus of services was EUR 400 million, 246 more than last year. It is unlikely, though, that tourism would have produced a turnabout, because we did not see any improvement in the international environment, the economic upswing materialised in EU Member States with a delay and at a slow pace, and the tightening measures in the welfare systems were not conducive to any upturn in the travel expenditures of households. The

[7] Because of methodological changes and the switch to a quarterly publication regime, the NBH will publish Q2 figures only on 30 September. In respect of the external equilibrium, we will have information about the first half-year developments only at that time.

[8] For details, see the section on foreign trade

most active summer months are in the third quarter, any improvement may present itself in that period.

…and the deteriorating income position attributable to the high interest rates.

At the end of April the net income outflow was HUF 1.4 billion EUR, 120 billion up on the previous year. 76% of the net outflow was related to non-debt investments (profit transfers and reinvestments), which is essentially the same as last year. Almost 60% of the deterioration of the net income outflow position relates to the increase of debt-type income, i.e., net interest expenditures. This occurred due to the increased debt stock and the relatively high ratio of Forint denominated debt in the environment of high Forint interest rates.

The active balance of current transfers was EUR 186 million at the end of April, 33 million less than a year ago. In view of the fact that we will also have outgoing payments as EU members, this item, which has produced a moderate bust stable surplus growth, may also fluctuate in the future, but for the whole year we expect the surplus to increase.

Non-debt creating financing has increased.

Foreign direct investments produced a positive change. In April a net inflow of EUR 180 million was registered, in contrast with the decline of last year, thus in the first four months the non-debt creating net capital influx amounted to EUR 1042 million, as opposed to EUR 453 million last year. The increase of EUR 589 million was attributable to the fact that EUR 300 million more FDI, at a total of EUR 930 million (of which EUR 500 million was reinvested earnings) came to Hungary and the value of portfolio investments, at 352 million, was also 130 million more than last year. The lower level of foreign direct investments by residents (EUR 237 million) also had a beneficial effect. Consequently, at the end of April, the financing ratio of the current balance of payments, which was EUR 560 million more than last year, was 37%, considerably higher than the 20% in the base period.

Improvement expected in the remaining part of the year.

Economic trends in the first half-year indicate that the current account deficit emerged against the background of a more sound structure, the dynamic growth of exports, the increase of our market share[9] and an upswing in investments, while the growth rate of household consumption has declined. These favourable trends are not yet reflected in the current balance of payments, as approximately EUR 0.7-0.9 billion of the deterioration expected by the end of the half-year will be related to the non-recurring effects of EU accession[10] and to the backlog of export data processing, rather than to economic processes. In the second half of the year we expect the deterioration of the external trade deficit below the base to slow down. However, due to the uncertainty of services and incomes, if the high interest rates decline slower and to a lesser extent than expected, we consider that the downside risk of our annual forecast may increase. The current account deficit may be around 8.5-8.9% of GDP. The EU transfers may somewhat reduce the external financing

[9] Cf.: Report on Inflation, August 2004, NBH
[10] Import purchases brought forward, statistical processing of goods accumulated in customs warehouses, etc.

requirement through the capital account, and we also expect a dynamic growth in the non-debt creating net capital inflow.

5. Monetary trends

5.1 Monetary policy

The base rate is still considerably higher than the level real economic processes would justify.

Despite the recent favourable trends in the Hungarian real economy, tight monetary conditions were maintained. Real interest rates soared, and the real exchange rate continued to appreciate over the corresponding period of the previous year. The tight monetary conditions impose additional burdens primarily on the budget. The corporate sector and households are able to get around expensive Forint financing using foreign currency funding, but the considerable open foreign exchange position of households also entails risks. The rising interest burdens of the general government also increase the volume of adjustments required in the primary balance.

Monetary conditions are tighter than the real economy would justify.

Today, the base rate of the Hungarian central bank is the highest in the European Union. The Monetary Council of the National Bank of Hungary continued to pursue a conservative interest rate policy after the publication of the previous report, thus the central bank base rate maintained its 11.5% level until mid-August. At its meeting of 16 August, the Monetary Council decided on a 50 basis point interest rate cut. Following the modification of the band last June, the central bank reduced the interest rate, which had been increased by 6 percentage points, only by 1.5 percentage points, though today the exchange rate is stronger than it was at that time.

Monetary policy continues to be restrictive, while substantial adjustments are expected in the budget for the whole year, real wages increase only very modestly and the consumer price index with constant tax content indicates the deceleration of inflation.

The markets generally expected the Monetary Council meetings after June to cut interest rates by 25-30 basis points, which tended not to happen. The conduct of the central bank obviously influences market expectations: the interest rate expectations for year-end increased from 9% to 10% by August.

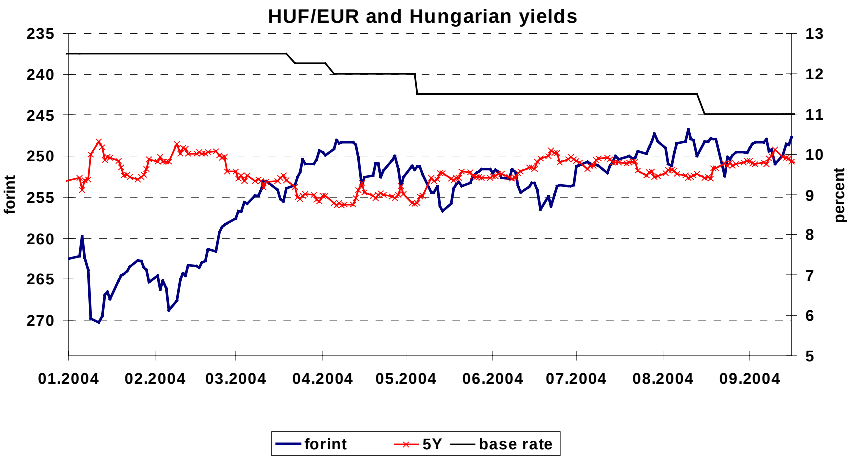
The schedule of Monetary Council meetings has changed: since June, the Council has discussed changes in the base rate only once a month, at the second meeting of the month. Accordingly, the Monetary Council sessions of 5 July and 2 August were not rate-setting meetings.

The Monetary Council explained its decision to cut interest rates on 16 August with the favourable trends on the global and regional markets, the sound structure of domestic growth and the current year's inflation peak being over. On the other hand, the central bank continues to emphasise that the external equilibrium and the general government deficit, expected to be higher than the target for the year, present substantial risks.

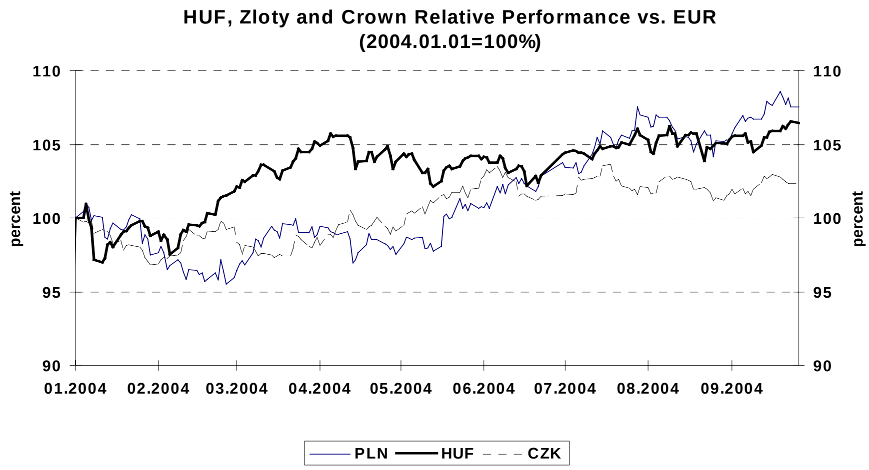
5.2. Exchange rate

The exchange rate considerably strengthened, its volatility decreased.

As a result of the positive changes in economic fundamentals and the improvement of money market confidence, the exchange rate has strengthened considerably, while showing decreasing volatility; in recent months its typical level was around 250 HUF/EUR. According to the expectations of analysts as surveyed in the most recent Reuters poll of 19 August, the exchange rate will continue to be strong (around 250-253 HUF/EUR) on the entire time horizon (until 2005), with interest rates being significantly lower than today.



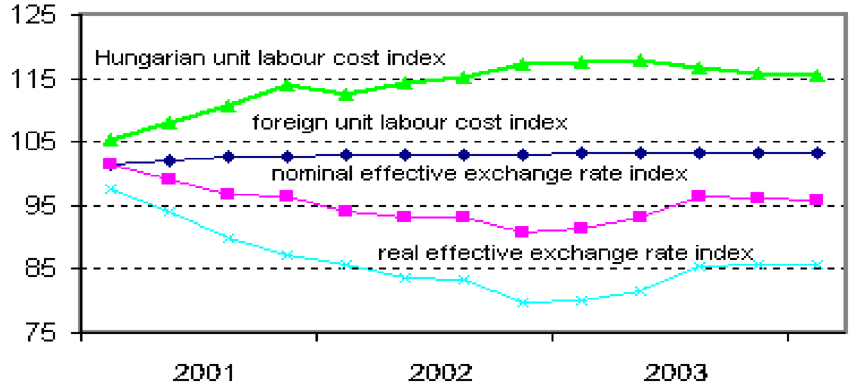
The comparison of the movement of the Czech Crown, the Forint and the Zloty reveals that in recent months the Forint has been more stable than the other two currencies.



A reversal occurred in the competitiveness trend.

2003 saw a reversal of the trend in terms of the competitiveness of the economy; following the approx. 16% price-based and 17% cost-based competitiveness deterioration during the previous two years, real appreciation was only approx. 1% both on a CPI basis and on the basis of the domestic sales price index of the manufacturing industry, while the index based on the unit labour cost of the manufacturing industry indicated that competitiveness stayed level. The deterioration of competitiveness had an adverse effect on exports and tourism and it is also reflected in the current account and in foreign direct investments. In addition to the nominal exchange rate, in recent years real appreciation was driven by the wage increases substantially exceeding the modest productivity growth.

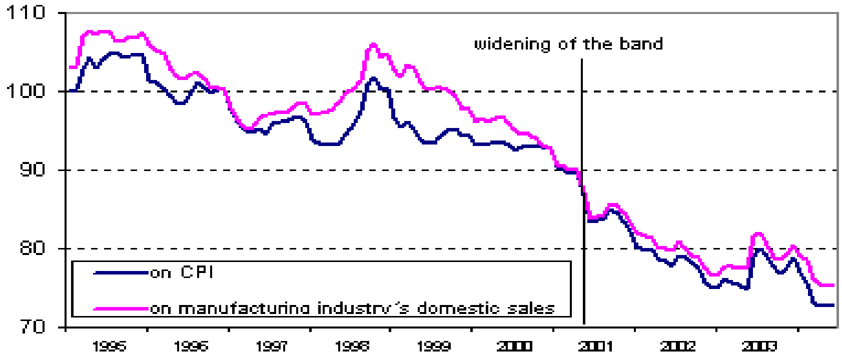
Real effective exchange rate index based on unit labour cost of manufacturing industry
(seasonally adjusted quarterly data, 2000=100)
values over 100 mean depreciation



The temporarily increasing inflation slightly worsens price-based competitiveness…

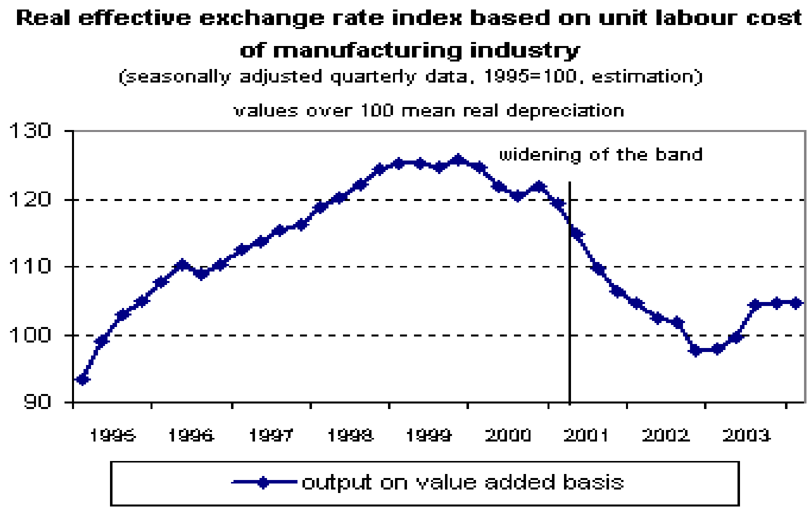
In the first half-year, the real effective exchange rate indices on the basis of the consumer price index and the domestic sales price index of the manufacturing industry both showed a deterioration of approx. 2% on a year-on-year basis, due to the temporarily accelerating inflation. As the annual average of the nominal exchange rate is expected to be around its previous year level, for the whole of the year we expect a price-based competitiveness deterioration corresponding to the inflation differential to our main trading partners. In case of a catching-up economy, fast growth is naturally accompanied by an equilibrium real appreciation on a CPI basis. If real appreciation results from the faster growth of the prices of the non-tradable sector, it does not constitute the deterioration of competitiveness. However, growth potentials can be exploited only with a real appreciation of 1-2% per annum at the most, as the average of a longer period.

Real effective exchange rate index based on prices
(seasonally non-adjusted monthly data, 1994=100, estimation)
values over 100 mean real depreciation



In a small, open and fast-growing economy, competitiveness is better measured by cost competitiveness rather than price competitiveness (where only temporary advantages can be gained in respect of manufacturing prices, or there is a trend of deterioration in terms of consumer prices). The real effective exchange rate index on the basis of the unit labour cost of the manufacturing industry showed an approx. 7% improvement in Q1 2004 over the corresponding period of the previous year (currently we have figures available for this period only); this was attributable for the most part to the weaker exchange rate, but the favourable tendency of unit labour cost was also reflected. The favourable development of competitiveness also contributed to the dynamic expansion of exports at a rate exceeding that of imports. The modest improvement of cost competitiveness expected for this year will be caused by the better consistency of productivity and wage increases.

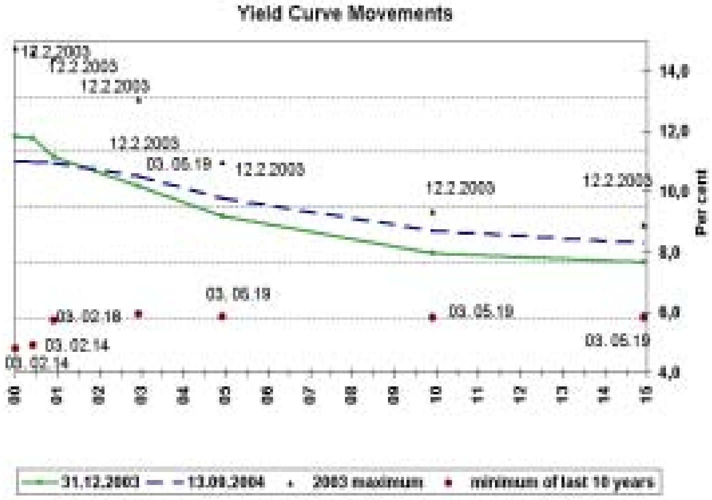
…but a modest improvement is expected in cost-based competitiveness.



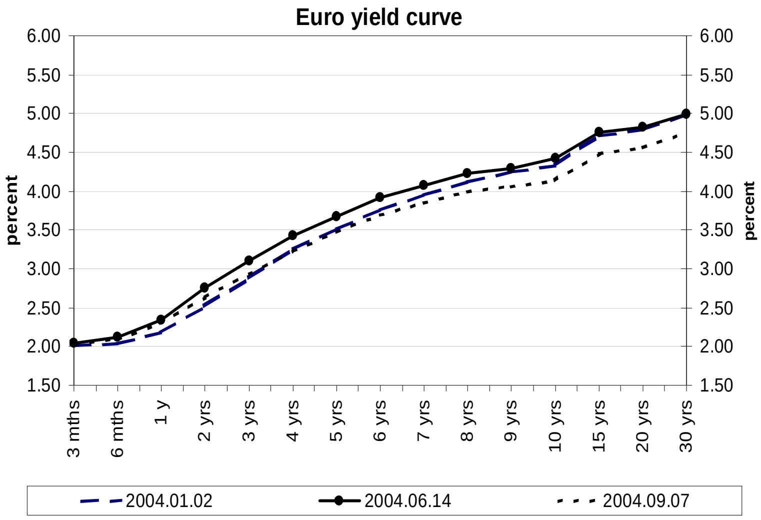
5.3 Yields and interest rates

After their drop early in the year, yields moved along a more varied curve after May. While short term yields were influenced by the base rate, thus in September they were below or around their levels in May and at the beginning of the year, the medium and long term portions of the yield curve moved less favourably. This trend showed a rising trend in recent months, which is in all probability related to the expected equilibrium indicators. As another reason for the absence of change in long term yields, the still high central bank base rate makes long term investments less attractive. As a result, long-term yields were even higher in September than in January. As a result, the yield curve became less inverse. Still, yields were less volatile than last year.

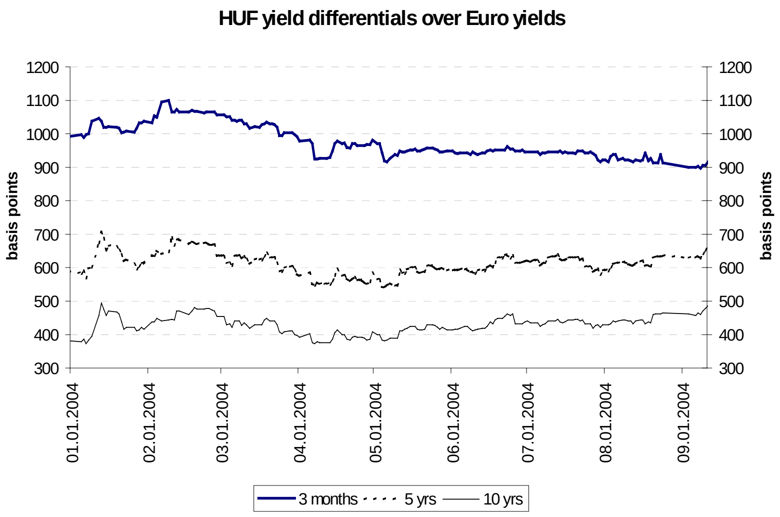
Against the background of permanently high yields…



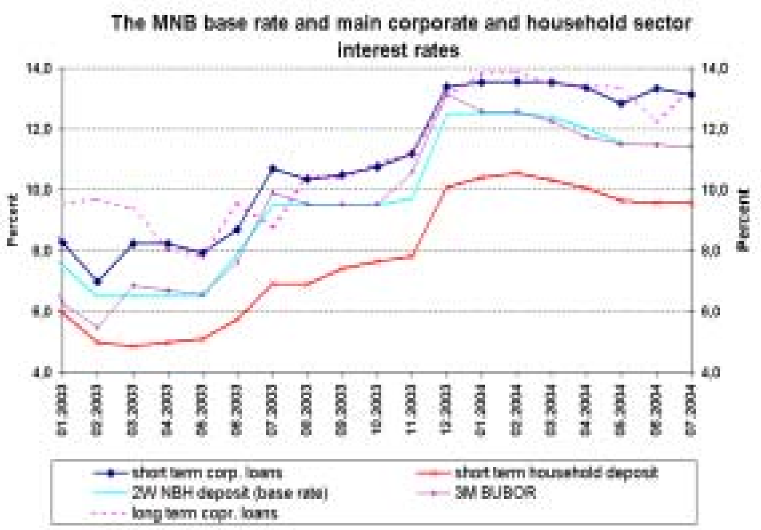
The development of Forint yields is explained by two main components: Euro yields and the Forint-euro yield gaps. After a low in March, euro yields continuously rose until June, then, after the clarification of uncertainties relating to the US interest raise cycle, they declined again. Early in September the medium and long term side of the yield curve was approx. 30 basis points below the level at the beginning of the year, while short yields remained essentially unchanged as the ECB did not change its base rate this year.



The spread between Forint and euro yields in the three-month segment narrowed slightly parallel with the lowering of the Hungarian base rate, but it is still more than 900 basis points. On the other hand, on longer maturities a rising trend of spread has emerged in recent months due to the rise of Hungarian yields and the decline of euro yields. Meanwhile, the spread of euro denominated Hungarian government securities continues to be stable.

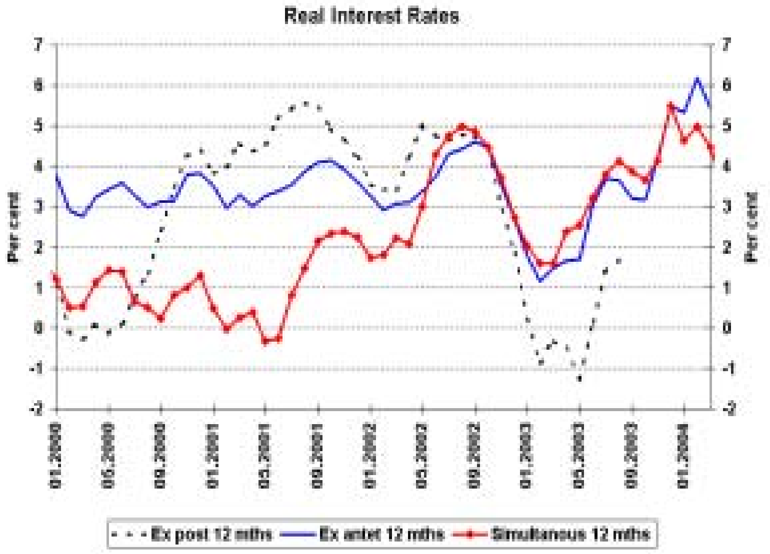


Bank interest rates have been considerably more stable in 2004 so far than they were last year, though the continuous, even though slow, decline of the year came to a halt by June-July. Considering the fact that the 300 basis point rate increase of November 2003 is still present to some extent in the base rate, the deposit and lending rates of banks are also higher than their year-end level. We have no accurate information available yet about the effects of the interest rate cut of August on bank rates, but banks are likely to have followed the central bank measure.



…real interest rates continue to be high.

The recent months witnessed a real interest rate rise: the ex ante real interest rate started to rise again as inflationary expectations subsided, but it did not reach its this year's peak. In accordance with expectations, the ex post indicator has also increased, turning positive again in June. We should expect a further increase in this indicator as the rising yields of the second half of 2003 are continuously incorporated into it, coupled with the declining inflation.



The ex-post real interest rate: yield of one year treasury bill issued 12 months ago, deflated by the current inflation. Ex ante: current one year treasury bill yield deflated by the inflation rate expected by analysts to develop in a year's horizon. Simultaneous: current yield to current inflation rate.

Budapest, 22 September 2004

TABLES

Table 1.

ECONOMIC INDICATORS

Real Sector, Prices, Competitivness

change from the same period of the previous year, %

	2000	2001	2002	2003						2004							
	I-IV. quarter	I-IV. quarter	I-IV. quarter	I. quarter	I. half of year	1 - 7 month	1 - 8 month	I-III. quarter	I-IV. quarter	1. month	1 - 2 month	I. quarter	1 - 4 month	1 - 5 month	I. half of year	1 - 7 month	1 - 8 month
GDP volume	5.2	3.8	3.5	2.7	2.6	-	-	2.7	2.9	-	-	4.2	-	-	4.1	-	-
Household consumption	4.8	5.9	9.3	7.2	7.1	-	-	7.3	6.5	-	-	3.0	-	-	3.9	-	-
Gross fixed capital formation	7.7	5.0	8.0	-1.6	0.5	-	-	1.9	3.0	-	-	18.9	-	-	13.5	-	-
Exports of goods and services	21.0	7.8	3.7	2.6	1.8	-	-	3.9	7.2	-	-	17.4	-	-	17.1	-	-
Imports of goods and services	19.4	5.1	6.2	4.5	6.3	-	-	9.2	10.3	-	-	16.6	-	-	17.6	-	-
Volume of retail trade turnover 14/	2.0	5.4	10.7	9.1	8.2	8.6	8.3	8.5	8.5	5.7	5.0	5.2	6.9	7.1	7.8	-	-
Volume index of investments	6.5	3.5	5.8	-1.2	0.5	-	-	2.1	3.1	-	-	18.9	-	-	13.5	-	-
Foreign trade turnover 1/: export volume	21.7	7.8	6,8 /12	2.8	2.0	3.4	4.2	5.7	9.1	19.9	20.4	20.1	18.4	17.4	17,9*	17,2*	-
import volume	20.8	4.0	6,1 /12	4.2	6.5	7.1	8.0	9.0	10.1	12.0	13.6	16.3	18.4	17.1	17,8*	16,2*	-
																-	-
Volume of industrial production	18.2	3.6	2.8	4.1	4.1	4.1	4.4	5.0	6.4	7.2	9.8	10.4	10.4	9.8	10.4	9.5	-
Volume of construction-installation activities	7.6	8.3	17.8	-14.3	-2.4	-1.6	-2.1	-0.2	2.0	18.5	17.4	15.5	12.7	8.4	7.6	-	-
Number of employees (in thousands)																	
household survey (annual average)	3 849.1	3 859.5	3 870.7	3 859.6	3 891.7	3 896.3	3 902.6	3 911.9	3 921.9	3 884.1	3 890.1	3 891.5	3 889.1	3 888.9	3 892.8	3 891.2	-
labour statistics 2/	2 718.1	2 720.8	2 726.1	2 721.2	2 737.4	2 740.4	2 742.9	2 746.2	2 752.8	2 763.3	2 764.7	2 768.6	2 774.2	2 779.6	2 784.2	-	-
Vacancies (in thousands) 3/	39.2	37.3	34.0	42.7	50.8	46.5	47.5	52.7	44.0	38.2	51.3	56.3	59.3	58.1	54.9	-	-
Number of unemployed (in thousands) 3/	372.0	342.8	344.9	386.2	336.2	344.6	347.4	344.7	359.9	388.0	401.7	396.9	378.4	361.6	350.7	-	-
Rate of unemployment (household survey, %)	6.4	5.7	5.8	6.4	6.1	6.1	6.0	6.0	5.9	6.3	6.2	6.1	6.1	6.0	6.0	6.0	-
	-																
Consumer price index	9.8	9.2	5.3	4.6	4.3	4.4	4.4	4.4	4.7	6.6	6.9	6.8	6.8	7.0	7.1	7.1	7.1
Index of industrial domestic sale prices	14.5	9.4	1.6	4.4	3.9	4.0	4.2	4.3	5.0	7.3	7.2	7.2	7.5	8.0	8.2	8.4	-
Index of industrial export sale prices	8.5	1.5	-4.5	-2.4	-2.0	-1.5	-1.1	-0.8	0.3	3.9	3.1	2.1	1.9	1.8	1.3	0.8	-
Agricultural production prices	22.5	4.9	-1.1	0.3	-0.4	2.6	3.2	3.2	5.3	14.4	14.9	14.5	13.5	15.5	14.7	7.6	-
Competitiveness 10/																	
based on manufacturing prices	-5.4	-9.0	-7.9	-5.2	-3.4	-2.7	-2.2	-2.0	-1.0	2.9	2.1	0.7	-0.2	-0.7	-1.9	-	-
based on CPI	-1.8	-7.6	-9.1	-5.4	-3.9	-3.2	-2.7	-2.5	-1.3	2.5	1.0	-0.4	-1.2	-1.5	-2.5	-	-
based on ULC (value added)	-2.4	-7.9	-9.7	-6.6	-4.7	.	.	-2.3	0.0	.	.	6.9	.	.	.	.	.

Table 2.

ECONOMIC INDICATORS

Income and Monetary Aggregates

change from the same period of the previous year, %

		2000	2001	2002	2003						2004							
		I-IV. quarter	I-IV. quarter	I-IV. quarter	I. quarter	I. half of year	1 - 7 month	1 - 8 month	I-III. quarter	I-IV. quarter	1. month	1 - 2 month	I. quarter	1 - 4 month	1 - 5 month	I. half of year	1 - 7 month	1 - 8 month
Average earnings:	gross	13.5	18.0	18.3	15.2	14.1	14.1	14.2	13.5	12.0	8.0	8.4	9.4	9.1	8.6	8.6	-	-
	net	11.4	16.2	19.6	19.1	18.1	18.1	18.1	17.0	14.3	6.9	7.2	8.0	7.8	7.4	7.4	-	-
Household	savings (HUF billion)	1 049.9	1 145.4	1 196.8	193.2	653.2	-	-	707.9	1 208.1	-	-	232.8	-	-	-	-	-
	credits (HUF billion)	245.4	391.8	769.9	196.2	508.8	-	-	838.5	1 166.1	-	-	184.5	-	-	-	-	-
General government GFS balance (HUF million) 4/		-480.2	-444.0	-1 685.6	-281.4	-600.3	-586.3	-707.6	-809.4	-1 094.5	-218.6	-341.3	-434.7	-547.6	-722.4	-1 040.2	-1 072.3	-1 192.3
Central budget	GFS balance (HUF billion) 4/	-368.7	-402.9	-1 469.6	-224.0	-458.6	-409.6	-481.4	-588.6	-732.4	-173.9	-246.7	-364.9	-426.9	-508.8	-855.5	-863.1	-926.8
	primary balance (HUF billion)	329.7	212.7	-832.0	-70.3	-89.5	0.9	-7.4	-69.8	-4.1	-141.5	-108.7	-186.3	-141.2	-169.8	-398.0	-369.2	..
	revenue change 4/	14.2	10.5	7.1	10.0	11.3	12.5	12.9	12.9	13.3	-11.7	5.5	8.1	7.3	5.8	5.6	3.3	4.0
	expenditure change 4/	13.7	10.4	30.4	11.6	13.7	13.9	13.4	13.4	-2.7	20.7	16.4	17.3	17.0	16.9	19.4	17.4	16.0
Social Security Funds 5/: balance		-81.4	-28.8	-100.9	-79.4	-169.3	-211.7	-261.8	-256.2	-349	-58.8	-115.3	-91.3	-146.5	-236.2	-208.2	-246.7	-301.4
	revenue change	10.7	18.6	17.2	20.5	16.7	15.2	14.0	15.1	4.5	4.3	4.1	8.5	8.8	8.5	9.5	16.2	9.6
	expenditure change	12.5	14.9	20.4	21.0	16.5	16.6	12.5	13.0	14.2	10.1	9.0	9.2	7.2	11.9	11.1	16.2	10.4
Government paper benchmark yielos (average annual) 6/																		
	3 month	11.80	9.80	8.24	6.27	7.63	9.57	9.53	9.41	12.16	12.21	12.58	12.10	11.58	11.35	11.46	11.43	11.12
	12 month	11.57	9.21	7.95	6.58	8.12	8.97	9.16	8.87	12.03	11.85	12.49	11.20	10.68	10.67	11.07	10.96	10.7
	3 year-bonds	10.74	8.17	7.37	6.64	7.86	8.47	8.58	7.97	10.16	10.29	11.16	10.36	9.71	10.12	10.6	10.6	10.11
	5 year-bonds	9.11	7.72	7.00	6.74	6.51	7.49	7.90	7.87	9.27	9.23	9.91	9.34	9.14	9.46	9.36	9.62	9.48
	10 year-bonds	9.04	7.06	6.44	6.50	6.08	6.75	7.70	7.22	8.02	8.13	8.75	8.22	8.19	8.44	8.46	8.40	8.36
	15 year-bonds		6.68	-	6.34	6.51	-	7.14	-	-	-	8.2	-	7.44	8.04	-	8.28	-
Interest rates 6, 7/:				-	-	-	-	-	-	-								
with maturity less than a year	credit	12.8	11.2	9.69	8.2	8.68	10.69	10.35	10.48	13.39	13.53	13.56	13.54	13.40	12.80	13.30	13.14	-
	deposit	9.5	8.4	7.41	5.11	6.57	7.98	8.14	8.44	10.96	11.06	11.07	11.22	11.20	10.60	10.60	10.70	-
with maturity more than a year	credit	13.4	11.2	9.71	9.37	9.53	8.79	10.47	10.35	13.04	13.84	13.88	13.49	13.40	13.40	12.20	13.37	-
	deposit	9.4	7.7	8.02	5.06	6.84	8.48	8.56	8.60	10.80	9.10	7.40	8.00	10.80	10.30	10.70	10.30	-
Increase of money supply 8/		12.9	17.2	18.9	12.9	20.6	9.8	6.8	19.3	10.1	15.7	8.4	5.5	10.7	12.2	15.9	13.8	-
Current account of balance of payments (mEUR) old methodology		-4 380	-3 613	-4 900	-1 488	-3 285	-3 808	-4 350	-4 703	-6 488	-453	-1 036	-1 705	-2 775	-	-	-	-
Without reinvested earnings		-3 309	-2 085	-3 018	-964	-2 977	-3 240	-3 516	-3 599	-4 520	-261	-651	-1 194	-2 273	-	-	-	-
Net foreign debt denominated in foreing currencies (bEUR) old meth.9/		7.4	4.5	5.6	6.0	6.5	-	-	7.2	8.2	.	.	8.7	.	.	-	-	-
BUX index 3/		7 865	7 122	7 739	7 423	7 782	8 288	9 060	8 930	9 627	10 064	10 242	10 992	11 072	11 285	11 537	11 680	12 171

METHODOLOGICAL REMARKS
for Table 1 and 2

Signs: * Preliminary data; **.** : data is not available yet; **-** : no data for the period

1/ Including industrial customs free zones. The Statistical Office price indexes are published quarterly;
the volumes for other periods are calculated with estimated price indexes.
2/ Data for firms with more than 5 employees and for budgetary institutions total.
3/ End of period data.
4/ Excluding privatization receipts. At the general government the interim data do not include the local governments.
5/ Total revenues and expenditures of the Pension Fund and Health Fund are not consolidated
with the non-self-provided services.
6/ The yield or interest in the last month of the period.
7/ At deposits with maturity longer than a month but not longer than a year.
8/ M3 does not include deposits with an agreed maturity over 2 years and debt securities with over 2 years' agreed maturity issued by motetary
financial institutions. However, it includes holdings by residents other than monetary financial institutions of MNB bonds with up to 2 years' agreed
maturity plus holdings by residents other than monetary financial institutions of investment units issued by money market funds.
9/ Excluding intercompany loans
10/ Price based indicators seasonally non-adjusted, unit labour cost based indicators seasonally adjusted
11/ As a consequence of correction of short term credits the net foreign debt has changed.
12/ There is a change in the statistical methodology from December 2002, therefore the CSO corrected only the annual volume indices.
According to the CSO publication exports went up by 5,9 % while imports increased by 5,1 % in 2002.
13/ Without part-time employees
14/Including sales of motor vehicles and antomative fuel

Table 3.

Main Indicators of the Hungarian Economy

2001 - 2004

	2001	2002	2003	2004	
				jun.	sept.
	fact	fact	prel.fact	expected	
				volume change over the previous year,%	
Gross Domestic Product	3.8	3.5	2.9	cca. 3,5	3,8 - 3,9
Domestic use of G D P	1.9	5.4	5.5	cca. 3	3,5 - 4
of which:household consumption	5.9	9.3	6.5	cca. 2	2,5 - 3
gross fixed capital formation	5.0	8.0	3.0	7 - 9	8 - 10
Foreign trade turnover (goods and services)					
Export volume change	7.8	3.7	7.2	10 - 12	12 - 14
Import volume change	5.1	6.2	10.3	9 - 11	11 - 13
				change in percentage of previous year	
Gross average wages	18.0	18.3	12.0	7 - 9	7 - 9
Net average wages	16.2	19.6	14.3	6 - 8	6 - 8
Real wages, per employees	6.4	13.6	9.2	0 - 1	0 - 1
Number of employees	0.3	0.1	1.3	0 - 1	0 - 1
Unemployment rate (ILO), %	5.7	5.8	5.9	5,8 - 6	5,9 - 6
Consumer price index (annual average)	9.2	5.3	4.7	cca. 6,5	cca. 6,8
				at current prices	
Deficit of foreign trade balance, Euro billion	3.6	3.4	4.2	4,1 - 4,4	4,2 - 4,5
Current account deficit, Euro billion	3.6	4.9	6.5	6,5 - 6,8	6,9 - 7,2
				in percentage of GDP	
Indicators in percentage of GDP:					
ESA95 general government deficit	4.4	9.2	6.2	cca. 4,6	5 - 5,3
Current account deficit	6.2	7.1	8.9	cca. 8,5	8,5 - 9

Table 4.

GROWTH RATES AND GROWTH PROJECTIONS ON THE WORLD ECONOMY

Percentage change in real GDP realtive to the preceding relevant period

Denomination	2001 (Economist)				2001	2002 (Economist)				2002	2003 (Economist)				2003	2004		2004
	Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4	(estimate)	Q1	Q2	Q3	Q4	(estimate)	Q1	Q2	(projection)
United States	2.5	1.2	0.6	0.5	0.3	1.5	2.2	3.2	2.9	2.4	2.0	3.3	3.5	4.4	3.1	5.0	4.7	4.5
Japan	-0.1	-0.7	-0.5	-1.9	0.4	-1.6	-0.7	1.3	2.6	0.3	2.6	3.0	1.8	3.5	2.6	5.2	4.5	4.5
Eurozone	2.5	1.7	1.3	0.6	1.5	0.3	0.7	0.8	1.2	0.8	0.8	0.2	0.3	0.7	0.5	1.3	2.0	1.8
Germany	1.6	0.6	0.3	-0.1	0.6	-0.2	0.1	0.4	0.5	0.2	0.2	-0.2	-0.3	0.0	-0.1	0.8	1.5	1.5
France	2.7	2.3	2.0	0.9	1.8	0.7	1.2	1.2	1.7	1.2	1.1	-0.3	0.4	1.0	0.5	1.7	3.0	2.2
Italy	2.3	2.0	1.9	0.7	1.8	0.1	0.2	0.5	1.0	0.4	0.8	0.3	0.4	0.1	0.5	0.7	1.1	1.2
United Kingdom	2.6	2.3	2.1	1.6	1.9	1.0	1.3	1.8	2.1	1.8	2.2	1.8	2.2	2.9	2.2	3.4	3.7	3.3
Austria	2.2	1.2	0.9	-0.4	1.0	-0.6	0.9	1.2	1.3	1.0	1.0	0.7	0.6	0.8	0.9	0.5	n.a.	1.6
Poland	2.3	0.9	0.8	0.3	1.1	0.5	0.8	1.6	2.1	1.3	2.2	3.8	4.0	4.7	3.7	6.9	n.a.	5.6
Czeh Republic	3.8	3.9	3.2	3.2	3.1	2.5	2.5	1.5	1.5	2.0	2.2	2.1	3.3	3.3	2.9	3.1	n.a.	3.3
Russia	4.0	4.0	4.9	4.3	5.0	3.7	4.1	4.3	5.2	4.3	6.8	7.2	5.7	6.2	6.8	7.4	n.a.	4.7

Source: EU Commission, IMF, Economist